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A Seller's Roadmap to REITLAND:
Private to Public Real Estate Transactions and Currency Selection

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by

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ABSTRACT

The purpose of this thesis is to articulate a practical decision-making framework for owners of private real estate portfolios interested in contributing their assets to a REIT. The framework introduces the private real estate owner, or contributing seller, to the entire transaction process. A transaction flowchart highlights important issues and their relationship and sequence to other aspects of the transaction. Text discussion follows the same organization as the flowchart, allowing the contributing seller to refer to detailed explanations of specific issues.

Issues discussed include: motivations of the contributing seller to divest, relevant income tax issues, the valuation of private real estate portfolios, currency selections and operating partnership (OP) units, financing ramifications, performing due diligence on REITs, transaction control provisions, post-transaction strategies, UPREITs, DownREITs, documentation, and seller representation. Case studies illustrate the issues presented.

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Chapter One: Introduction

Purpose of Thesis

The purpose of this thesis is to develop a decision making framework for a private real estate owner to contribute his assets to a REIT for cash, stock, operating partnership units, or a combination thereof. The thesis is also intended to inform real estate owners unfamiliar with the changes and opportunities presented by the recent developments in the real estate capital markets of new opportunities relating to divestment, portfolio diversification, tax deferral strategies, and estate planning. Throughout the thesis we use the term contributing seller to refer to private owners of real estate.

Organization of Thesis

The decision-making framework is constructed around relevant issues relating to the contribution of privately-held real estate assets to a public REIT, as identified in discussions with real estate professionals, contributing sellers, financial analysts, and attorneys involved in recent transactions. The issues are organized to reflect the sequential thought process involved in completing such a transaction. Accordingly, motivational factors are discussed first, and topics such as post-transaction strategies are explained later.

Chapter Two includes a review of the definition and history of REITs. This section is intended for readers unfamiliar with REITs and their recent development. Chapter Two also deals with the range of contributing seller motivations to enter into a contribution transaction. Obviously, each contributing seller is motivated by a unique combination of factors. Our research, however, reveals some common motivations. These generally include opportunities to:

1. diversify real estate investment exposure,
2. achieve greater liquidity,
3. offer solutions for estate planning goals,
4. handle partnership relationships,
5. secure a continuing management role for key employees,
6. and benefit from the current pricing in the real estate asset markets.

Chapter Three addresses financial, tax, and business planning issues. With respect to taxes, the ability to defer taxes is a fundamental aspect of transactions between REITs and contributing sellers. In this regard, we have reviewed relevant tax issues including:

1. differences between a tax free vs. taxable entity,
2. determination of taxable basis, and
3. the contributing seller's taxable position and its implications for the contribution transaction.

After the contributing seller analyzes his tax position, the next step in the transaction process is evaluating the portfolio of assets to be contributed to the REIT partnership. This section explores the evaluation process with regard to the value of the underlying assets, as well as management, and management contracts, if such employees and contracts are part of the contribution. REIT pricing strategies and issues relevant to private asset portfolio valuation will also be explained. The thesis does not detail how to value the contributing seller's portfolio, rather it discusses unique valuation issues relating to contributing private assets to a REIT partnership.

When the contributing seller has clarified both his tax position and the value of his asset portfolio, he should decide what is the optimal currency combination to receive in exchange for contributing his assets. In this section, currency types and characteristics are explained. The liabilities and benefits of different currency positions are analyzed. Contributing sellers' have three basic types of currency to choose from, as well as combinations thereof. Each currency has positive and negative characteristics, depending on the contributing seller's tax position and goals. This section examines the characteristics of:

1. Cash
2. Stock
3. Operating Partnership Units (OP units)
4. Conflicts of interest between OP unit holders and stockholders
5. Legislative and financing risks associated with OP units.

Contributing a private portfolio of assets raises issues associated with the contributing seller's outstanding debt on the assets. We will discuss strategies for protecting contributing sellers from income tax liabilities associated with debt repayment, specifically, the assumption of debt by the REIT and bottom dollar guarantees.

In the course of a contribution transaction, the contributing seller will need to evaluate both the transaction terms offered by a REIT as well as the REIT itself. The evaluation process includes examining the REIT's strategic goals, management competence, assets, and financial condition. This section begins with a review of REIT activity, including discussing the acceptance of REITs in the marketplace, as well as REIT returns and capitalization. Current evaluation strategies employed by contributing sellers when transacting with REITs are explained, as well as REIT due diligence.

Control issues are directly related to the financial terms of a contribution transaction between a REIT and a contributing seller. In this section, we will analyze common provisions dealing with control issues and discuss the relationship of these issues to financial terms. We will examine the following issues:

1. Lock-Out provision
2. Make Whole provision
3. Lock-Up period
4. Black-Out period
5. Board Seat
6. Management Participation
7. Depreciation Control
8. Financial Covenants
9. REIT Partnership Structure

At the conclusion of Chapter Three, we discuss post-transaction issues. This section focuses on two developing post-transaction options for OP unit holders: borrowing against their OP units and exchanging their units for securities in a diversified OP unit fund. Some lenders who are familiar with OP units, or that have unit holders as clients, will lend against OP units or REIT stock. A financial advisory firm has begun plans to initiate an OP unit fund. Such a fund potentially offers holders of illiquid OP units to achieve greater diversification and liquidity than if they retained their units. We wish to stress that such funds are only in the development stage.

Chapter Four deals with UPREITs and DownREITs, as well as a comparison of their positive and negative qualities. Since many UPREIT issues are discussed in other sections, the chapter focuses primarily on the DownREIT. The practical (and, to some extent, technical) differences between the different REIT vehicles are explained in addition to the implications involved in converting to an UPREIT structure from a DownREIT.

The next section examines the documents necessary to exchange real estate assets for a combination of cash, stock, and OP units. A contribution transaction involving a REIT requires documentation that the contributing seller is likely to be unfamiliar with. We will examine the following documents:

1. The Contribution Agreement
2. Prospective Subscriber Questionnaire
3. Registration Rights Agreement
4. Tax Protection Agreement

At the conclusion of Chapter Four, we discuss contributing seller representation issues, including, tax, legal, financial, and brokerage advisory services. Contribution transactions involving a REIT present a range of potentially unfamiliar issues to a contributing seller with experience in commercial real estate transactions between private parties.

Chapter Five presents case studies of transactions to highlight the integration of issues and motivations. The following transactions are examined:

1. Baur Properties and Duke Realty Investments, Inc.
   - A St. Louis office and industrial portfolio
2. Joseph P. Kennedy Enterprises and Vornado Realty Trust
   - A commercial portfolio highlighted by The Merchandise Mart in Chicago
3. Carefree Resorts and Patriot American Hospitality, Inc.
   - A Resort portfolio in Arizona and Colorado

In addition to some concluding observations and comments following the case studies, an appendix contains; a diagram of the decision-making framework, general information on the financial examples used in the text, the definition and an example of a 1031 tax-free exchange, and an a list of issues presented to a contributing seller at the outset of a potential transaction.

Chapter Two: REIT Review & Motivational Factors to Sell

We will review the definition, recent history, and capital constraints of REITs. We will then explain the factors motivating a contributing seller to exchange his assets with a REIT in exchange for a combination of cash and securities.

REIT Review

A REIT (real estate investment trust), created in 1960, is a corporation or business trust that pools capital from many investors to acquire or finance real estate or loans secured by real estate.[1] There are three principal kinds of REITs. Equity REITs invest in real estate directly. Mortgage REITs invest primarily in mortgages and construction loans. Hybrid REITs function as both Equity REITs and Mortgage REITs. REITs are exempt from corporate level taxation as long as at least 95% of their taxable income is distributed to shareholders, with the dividends taxed as ordinary income.[2] There are other formation and governance requirements that REITs must meet in order to qualify for favorable tax-exempt treatment by the Internal Revenue Service. This thesis discusses aspects of the REIT partnership structure, while investment texts and real estate journals describe REITs in detail.

The Umbrella Partnership REIT, or UPREIT, was created in 1992 to provide a vehicle for private owners of real estate to divest their real estate holdings to REITs and defer their tax liabilities on capital gains and depreciation. The IRS has tentatively approved the UPREIT structure. The UPREIT allows the creation of an Operating Partnership in which the REIT is typically the general partner and property owning entities are limited partners. The REIT provides cash to the operating partnership while the contributing sellers contribute their properties in exchange for operating partnership units, or OP units.

The UPREIT structure avoids a violation of the IRS "five or fewer" rule. The "five or fewer" rule is that no more than five or fewer investors may own 50% (by value) of the interests of the REIT during the last half of the taxable year.[3] By utilizing limited partnership units, or OP units,

[1] "The REIT Story", NAREIT Idea Exchange, 1997
[2] Zvi Bodie, Alex Kane, and Alan Marcus, Investments, 3rd ed., (Chicago: Irwin, 1996) pp. 112-113
[3] Internal Revenue Code 542(a)(2)

as currency, UPREITs enjoy advantages over other potential buyers of a private real estate portfolio. An UPREIT, unlike a traditional REIT, offers the contributing seller the ability to continue to defer taxes. UPREITs are able to outbid both REITs and private companies, by the value of the contributing seller's tax deferral, for private portfolios. With the advent of the DownREIT, traditional REITs may now compete with the UPREITs.[4] A DownREIT, to be discussed separately in detail, is created by the REIT for a specific transaction and is similar to an UPREIT in terms of tax deferral and other characteristics.

Summarizing, there are three types of REIT variants: REITs, UPREITs, and DownREITs. In order to offer contributing sellers the ability to defer taxes, existing REITs created DownREIT partnership structures for individual transactions.

Recent History

The growing size and influence of REITs on the real estate sector create new opportunities for private real estate owners. REITs have rapidly expanded their holdings over the past five years. In 1992, REIT market presence was $10 billion. By 1997, this had ballooned to $142 billion with sixty-eight new REITs forming.[5] There is still room for growth in the REIT sector as REITs' held only a 4% share of the overall real estate market at the end of 1997.[6] The expansion of the REIT sector, coupled with pressure from shareholders for continued growth, lead REITs to search for acquisition opportunities. Private real estate holders may satisfy this demand by contributing their assets to REIT partnerships.

In 1996, REITs returned 35% on average, and 19% last year. Returns in the REIT sector are down approximately 10% to 15% in 1998.[7] However, analysts we spoke with predicted that current REIT returns will not discourage industry growth and merger activity in the short term.

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[4] "Industry Overview", Real Estate Investment Trusts, 1.02[4][c]
[5] "NAREIT Annual Market Capitalization", NAREIT Document on Demand #211, June, 1998
[6] Timothy Riddiough , "Real Estate Capital Markets Course Notes", MIT, Spring 1998
[7] "Most Recent Summary Performance", NAREIT Document on Demand #201, June 1998

REIT Capital Constraints

Contributing sellers should understand a REIT's limitations regarding access to capital prior to engaging in any transaction. The REIT dividend requirement eliminates to a large extent the ability of a REIT to retain earnings for use in financing external growth. The lack of internal capital for acquisitions constricts the REIT but creates opportunities for the private seller. The earning retention restriction means REITs can finance growth in the following ways:

1) make additional share offerings in the public capital markets,
2) issue debt, or
3) issue OP units to contributing sellers.

REITs transacting with a contributing seller with OP units allow REITs to grow without having to pay out cash and raise additional capital. Public offerings, with their high transaction costs, are a less efficient means of acquiring capital. Additional public offerings may also depress share price.

In addition, a contribution transaction (particularly if small in comparison to total REIT market capitalization) offers an opportunity to acquire properties without the media coverage that accompanies a merger between two public companies. Contribution transactions are often accomplished away from the scrutiny of the financial media, minimizing news driven share price volatility.

Motivational Factors to Sell

This chapter presents specific motivations contributing sellers have in deciding to divest all or a portion of their real estate holdings. While the tax deferral benefit of contributing assets to a REIT is often considered the sole or principal motivator, this thesis argues that tax deferral alone is not a motivation to sell. Indeed, there would be no tax liability to the owner if he simply chose to continue to hold his assets. The benefit of tax deferral, depending on the currency selected, is a prime addition to the equation. This benefit needs to be understood by the private owner of real estate and will be analyzed later in this thesis. This thesis argues that the following are the motivational drivers of transactions, and that they do not work on a stand-alone basis; rather, it is the combination of these factors that create the desire to sell.

Diversification

A contributing seller may obtain a more diversified portfolio when contributing its properties to a REIT. The key to portfolio management has always been to mitigate as much risk as possible, given an investor's specific risk tolerance levels. Diversification has been a hallmark for risk-averse investors. REIT transactions will allow the contributing seller to find diversification to varying degrees.

The contributing seller will achieve meaningful portfolio diversification only if he is invested in multiple sectors, including the stock and bond markets, commodities, etc., as well as real estate. Contributing assets to a REIT will not guarantee broadly diversified holdings. However, if cash is selected in the transaction, the contributing seller could enter into other financial investment vehicles. Diversification benefits, within the context of this thesis, are meant to suggest a more diversified real estate portfolio.

Product type diversification of a contributing seller's portfolio is often expanded in REIT transactions. A local or even regional developer may only have expertise in one specific asset class. In contributing to a diversified REIT, the contributing seller's resulting real estate investment exposure will be broadened to include multiple property types. Mr. Birch Mullins, formerly a principal with Baur Properties, was involved in the contribution of assets to Duke Realty. His portfolio included both industrial and office properties, but the asset mix was not ideally balanced in terms of income production, in his estimation. Upon executing the UPREIT transaction with Duke, his investment portfolio now includes approximately two-thirds industrial and one-third office properties, but the office and industrial sectors each produce one half of the income of the portfolio.[8]

Locational diversification may also be achieved in an asset contribution with to an UPREIT. Mullins' portfolio was focused in St. Louis. After the transaction with Duke, Mullins has real estate exposure across eight cities. Local expertise allows area developers to succeed in a market. However, in a market downturn the entire portfolio is at risk. Diversification in various

[8] Interview with Birch Mullins, Duke Realty, St. Louis, MO. Interview July 15, 1998

regions reduces overall portfolio risk. Given an investor's overall risk profile, locational diversification is another driver for private to public real estate transactions.

Liquidity

Contributing assets to a REIT increases the liquidity of the contributing seller's portfolio. Owning physical real estate is a relatively illiquid investment vehicle. When owners wish to sell a portfolio of assets it creates more difficulty in realizing the value of their investment. For instance, an owner of roughly 50% of the class A office space in Albany, NY has access to only a small percentage of his overall wealth. Contributing his assets to a REIT provides several advantages. Depending on the currency selected in the transaction (cash, stock, or OP units - discussed in further detail in Chapter Three) he will retain an investment exposure to the real estate sector. He will have divested his portfolio of illiquid assets in exchange for cash, stock, and/or OP units. Each type of currency has its own liquidity characteristics, and all are arguably more liquid than the physical assets.

The contributing seller is now able to further diversify his portfolio by allocating funds into other investment sectors. This provides opportunities to the contributing sellers that, potentially, were previously unavailable given his prior portfolio mix. Further sources of liquidity, including lending against OP units, will be analyzed later in this thesis.

The desire for diversification raises the issue of whether owning stock in a REIT is similar to owning other financial assets or physical real estate assets. This issue has been widely debated and is beyond the scope of this thesis. However, research has shown that the correlation between REIT stocks and real estate is significant. The research of Ghosh, Miles, and Sirmans supports this contention.[9] While current conditions do not guarantee future market fundamentals, at this time it is generally accepted that REITs act more like real estate than stock. Combined with greater liquidity, creates a benefit to the REIT stockholder that is unavailable to the physical asset owner. The nature of the liquidity of REIT stocks and OP units will be discussed in Chapter Three. For the purpose of identifying motivating factors for transactions, it is sufficient

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[9] Chinmoy Ghosh, Michael Miles, and C.F. Sirmans , "Are REITs Stocks?", Real Estate Finance, Fall 1996.

to state that an investment in a REIT provides significantly more liquidity than a direct investment in real estate.

Estate Planning

Succession planning is another motivator in private to public real estate transactions. Certain owners of real estate assets may not have any heirs to carry on their business ventures. In other instances, the next generation may not be prepared to work in real estate given their youth or simply their lack of interest. Under these circumstances, becoming a contributing seller to a REIT would benefit owners whose heirs have no interest in real estate. It should be noted that OP units could be transferred after a negotiated lock-up period, (typically 12 months) to heirs without the consent of the REIT.[10]

The interests of the parties involved in estate planning are crucial to understanding the motivation behind contributing one's assets to a REIT. The owner must determine his own consumption needs and retirement plan. He must also consider the amount of time he is willing to continue working in his later years. Additionally, the owner's wealth may be tied up in a large concentration of real estate. Given age and risk aversion levels, it may be time for a more diversified, liquid portfolio. Also, there is a step-up in basis upon death for a surviving spouse or heir. This would allow conversion of any OP units to shares without a tax liability. Estate planning is simpler when the owner has no heirs.

Estate planning is a motivational factor for contributing sellers who have diverse family interests. For the purpose of this thesis, heirs will be distinguished by two classifications; those who wish to continue focusing on real estate and those with other interests. The contributing seller can satisfy the needs of both groups in a REIT transaction involving cash, stock and/or OP units.

First, heirs with interests other than real estate can be satisfied with the liquidity gained from REIT transactions and the divestiture of the physical real estate from the family portfolio. Second, heirs with a desire to remain in real estate can be satisfied in several ways. Most simply, it is possible that the current owner of the real estate company would choose not to sell and allow

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[10] Interview with Minta Kay, Goodwin Procter & Hoar, Boston, MA, June 16, 1998.

the heirs to continue the further operation of the company. Additionally, it is possible to divest only a portion of the portfolio to satisfy the liquidity issues associated with family members who wish to leave the real estate industry. Finally, the contributing seller can negotiate that the REIT must retain the management services provided by the contributing seller.

A prime example of such a solution involves the Kennedy family's sale of the Merchandise Mart in Chicago, Ill. In 1945, Joseph P. Kennedy purchased the Merchandise Mart in the process of building one of the wealthiest and well-known family empires in American history. On January 26, 1998, Vornado Realty Trust purchased the building and two others for over $625 million dollars. The press releases from the Kennedy family noted that it provided the Kennedy family with additional liquidity and the diversification of its assets. Christopher Kennedy, son of the late Senator Robert Kennedy, has remained actively involved with the Merchandise Mart even after the transaction. The family negotiated an employment agreement for Christopher Kennedy to remain the Executive Vice President of Merchandise Mart Properties, Inc. for a period of at least five years. This illustrates family members both with and without an interest in remaining in real estate can benefit from a private to public real estate transaction.

Partnership Relations

The current partnership structure of a private real estate company could also create a desire to sell. Typical companies and/or assets are owned in a limited partnership or limited liability company structure with several if not many limited partners and multiple general partners. A general partner may wish to gain more control or independence in his investment activities. Previously, the general partner was dependent upon this structure to raise capital, invest in the real estate sector, and defer taxes.

The opportunity to contribute assets to a REIT provides several benefits for the general partner. It would allow for separation from an unwanted or inefficient business relationship. Investment goals are unique to the individual and it would be difficult to find partners that share the same acquisition, asset management, and disposition strategies for an entire portfolio of assets. A transaction outlined by this thesis would allow for individual control over a contributing seller's personal investments since he would have an interest in the REIT rather than the specific assets.

Further, as mentioned above, a portfolio would gain greater liquidity, depending upon the currency selected. Currency selection issues will be outlined in detail later in this thesis.

Reduced Role in the Management of a Real Estate Portfolio

Maintaining a management role could be considered in the succession planning issues of estate planning. However, contributing sellers have commented that despite entering a transaction, they have no interest in religuishing a management role for themselves and are not concerned with heirs or even retirement. There are a few options for contributing sellers who seek a reduced role in real estate operations, and wish to avoid having to make day to day decisions.

First, they could elect to maintain stock in the REIT and have no input in the management process. If they disagree with management decisions they have the right to sell the stock and invest in another REIT. Second, the contributing seller could negotiate a reduced or part time position in the management of the assets. While Mullins was previously a full time employee with Duke, he is now in a part time role as his interests lie more with his family and less with work at this stage of his career. Third, if the contributing seller has a significant portfolio, between 10% and 15% of the market capitalization of the REIT,[11] he could negotiate for a board seat of the REIT. This allows for input in the direction the REIT will take in the future, but removes the contributing seller from the daily operations of the REIT. This decision must be made carefully however, given the responsibility board members have to look after the shareholders' interest at large. There may be conflict between what is best for a former contributing seller and the shareholders on issues that would effect the contributing seller's tax liabilities. The issues board members face will be explored in the legal issues in Chapter Four.

Investment Sales Market

Real estate values have recovered from the early 1990's to levels that have not been seen since the late 1980's. Current pricing allows private contributors to receive an attractive price for their assets plus the premium of the taxed deferral benefit. Example 2-1 illustrates this benefit to the

[11] Interview with Scott Tully, AEW, Boston, MA, June 15, 1998.

contributing seller. This simple example demonstrates that if a building is sold for $50 million to a REIT for OP units or to a private institution for cash there is a clear financial benefit to the contributing seller, realized in the form of the value of the tax deferral. This example ignores the possibility of 1031 exchanges and the fact that most transactions do involve a cash or stock component, which is taxable. Its purpose is to illustrate the source of the perceived benefit that is available with private to public asset transactions.

Example 2-1

For simplicity, this example assumes an all cash or all Operating Unit transaction.
The purpose is to illustrate the net proceeds differential based on tax deferral benefit.

This example is based on a sale at the end of the 30th year of ownership.

		Cash Transaction Taxable Entity	Cash Transaction Tax Exempt Entity
Tax Analysis:			
Sale Price		$ 40,000,000	$ 40,000,000
Adjusted Basis		11,076,923	11,076,923
Gain On Sale		28,923,077	28,923,077
Gain from Depreciation		21,923,077	21,923,077
Capital Gain		7,000,000	7,000,000
Tax Liability:			
On Depreciation		5,480,769	-
On Capital Gain		1,400,000	-
Total Tax Liability		6,880,769	-
Cash Analysis:			
Sale Price		40,000,000	40,000,000
Less: Transaction Costs @	1%	(400,000)	(400,000)
Net Sales Price		39,600,000	39,600,000
Less: Outstanding Debt		(18,616,327)	(18,616,327)
Less: Income Taxes		(6,880,769)	-
Net Sales Proceeds		**$ 14,102,904**	**$ 20,983,673**

Mr. Scott Tully, an analyst at AEW Capital Management, feels that this pricing discrepancy will eventually disappear as the REIT market matures. It is his opinion that the REITs are willing to give this ‘premium’ in pricing to the contributing seller as the REIT is interested in creating “beachheads” of assets. He feels that the REITs want to reach a critical mass, develop a market presence, and an asset portfolio consistent with their management strategy.

There is currently competition amongst REITs to reach this critical mass. Once this beachhead is created the REITs will begin to pay 'less than market for the assets' by the value of the tax deferral premium. In other words, they will absorb the benefit of the tax deferral that only they can offer a private owner of assets.

Private contributing sellers need to be aware, however, that this tax deferral may not be guaranteed. The REIT's stock price needs to remain constant or increase over time to ensure there will be a premium paid in the transaction when OP units or stock shares are taken in exchange for properties. If the contributing seller's security portfolio loses value after the transaction the premium may be lost. This is one of many reasons that proper due diligence on the REIT is essential. In contribution transactions, the contributing seller is not simply selling his assets, but he is investing long term with a public company. He must view the transaction with a long-term perspective.

REITs are currently involved in many contribution transactions despite their stock prices falling roughly 10% from 1997 levels. Despite their desire to avoid secondary offerings at current prices, they are still actively involved in the purchase of private real estate portfolios. REITs are capable of participating is 'stealth transactions' involving purchasing real estate with OP units. Wall Street analysts are generally more concerned with secondary offerings and how they affect a REIT's market value, than they are with the private placement of stock and OP units to contributing sellers. This is especially true if the asset portfolio being acquired fits the growth strategy and asset quality parameters of the REIT.

Chapter Three: Financial Issues Involved with REIT Transactions

Now that the motivational factors driving REIT transactions have been examined, we will investigate the financial issues involved with REIT transactions. This chapter will identify and examine such issues from the perspective of the taxable contributing seller. This chapter focuses initially on taxes, evaluating a private portfolio, and currency issues. The final portion of the chapter addresses REIT evaluation, control provisions, and post-transaction strategies.

Relevant Tax Issues

A REIT transaction allows the taxable contributing seller to exchange real estate assets for both liquid, and relatively illiquid securities, and in some cases continue to defer taxes on capital gains and depreciation. This section will guide a contributing seller through the taxation process, beginning with evaluating the contributing sellers' current tax position, and ending with the implications of the resulting tax position. While non-taxable entities also transact with REITs, this thesis is primarily geared toward business and tax issues faced by taxable entities. Example 3-1(below) reviews the impact on net sale proceeds between a taxable and a non-taxable entity, as well as identifying the magnitude of the taxes deferring at closing.

Before proceeding with the initial steps of a transaction, understanding the contributing seller's tax position is crucial. Contributing sellers should assemble and provide the relevant accounting documents to their tax advisor at the outset of any possible REIT transaction.

Basis

The contributing seller's adjusted tax basis in an individual asset or a portfolio of assets is an important variable in the analytic process. A contributing seller's adjusted tax basis is equal to his original cost basis, plus the cost of any improvements made to the property, less the sum of all tax depreciation deductions claimed. Depreciation deductions are determined by calculating the property's depreciable basis (generally cost basis plus improvements minus the value of the land) and dividing it by an appropriate depreciable life, as specified in the tax code.

Example 3-1

For simplicity, this example assumes an all cash transaction. The purpose is to illustrate the lower net proceeds to the taxable entity.

This example is based on a sale at the end of the 30th year of ownership.

		Cash Transaction Taxable Entity	Cash Transaction Tax Exempt Entity
Tax Analysis:			
Sale Price		$ 40,000,000	$ 40,000,000
Adjusted Basis		11,076,923	11,076,923
Gain On Sale		28,923,077	28,923,077
Gain from Depreciation		21,923,077	21,923,077
Capital Gain		7,000,000	7,000,000
Tax Liability:			
On Depreciation		5,480,769	-
On Capital Gain		1,400,000	-
Total Tax Liability		6,880,769	-
Cash Analysis:			
Sale Price		40,000,000	40,000,000
Less: Transaction Costs @	1%	(400,000)	(400,000)
Net Sales Price		39,600,000	39,600,000
Less: Outstanding Debt		(18,616,327)	(18,616,327)
Less: Income Taxes		(6,880,769)	-
Net Sales Proceeds		**$ 14,102,904**	**$ 20,983,673**

In many cases, contributing sellers are interested in contributing a portfolio of assets. The contributing seller's basis in each asset must be calculated. A schedule may be created in which the contributing seller lists his assets, sorted by adjusted basis. Gain is realized on a sale or contribution equal to the difference between the sale price and the adjusted basis of the property. Gain is then broken out between accumulated depreciation and all other (capital) gain. Depreciation and capital gain are taxed differently, at 25% and 20%, respectively.

Currently, commercial properties are depreciated on a straight-line basis over 39 years. Example 3-2 reviews the calculation of both depreciable basis and adjusted basis for our general example.

Example 3-2		
Determining the Adjusted Tax Basis in Year Thirty of the Holding Period		
Years of Ownership		30
Purchase Price		$ 30,000,000
Plus: Capital Improvements		3,000,000
Cost Basis		33,000,000
Less: Value Attributable to the Land	(4,500,000)	
Depreciable Basis	28,500,000	
Depreciation per year	730,769	
Total Depreciation for holding period		21,923,077
Adjusted Tax Basis		**$ 11,076,923**

In addition, a market value for each asset may be indicated, allowing the contributing seller to estimate the capital gain or loss on an individual asset, and the portfolio as a whole. The goal of analyzing the contributing seller's taxable position is to have a clear understanding of expected total capital gain or loss.

Taxation is a broad and complicated subject; a full explanation of tax issues relating to real estate is beyond the scope of this thesis. Since UPREIT and DownREIT transactions allow contributing sellers to defer tax payments, we have restricted our discussion of taxes to issues relevant to these transactions. Seeking professional tax advice with respect to all commercial real estate transactions is recommended.

Taxable Position

There are three possible outcomes relating to a contributing seller's taxable position: taxable gain, taxable loss, and no significant tax impact. In many cases, contributing seller's face a significant tax liability upon the disposition of their assets in a taxable transaction, such as a traditional outright sale between private parties. Therefore, the situation in which the contributing seller faces a capital gain will be discussed first, followed by the two other scenarios.

Taxable Gain

A taxable gain results when the sale price is greater than the contributing seller's adjusted tax basis, see Example 3-3.

Example 3-3

This example calculates the gain on sale , and illustrates its impact on the contributing seller's tax liability at closing. This is based on a sale at the end of a thirty year holding period.

Tax Analysis:	
Sale Price	$40,000,000
Adjusted Basis	11,076,923
Gain On Sale	**28,923,077**
Gain from Depreciation	21,923,077
Capital Gain	7,000,000
Tax Liability:	
On Depreciation	5,480,769
On Capital Gain	1,400,000
Total Tax Liability	$ 6,880,769

In a transaction involving a REIT, the contributing seller has three basic choices of currency in which to be paid: cash, stock, and OP units. These currencies, especially OP units, will be discussed thoroughly in a separate section. From a tax standpoint, cash and stock are equivalent currencies, and receipt of either triggers a taxable event. Receipt of OP units does not create a taxable event, and therefore, allows a contributing seller to defer tax payments. If the contributing seller faces a significant capital gain upon sale, receipt of OP units will allow the contributing seller to defer his tax liability. Refer to Example 2-1 to review a transaction involving all cash and stock with a transaction involving OP units.

Taxable Loss

A taxable loss occurs when the contributing seller's taxable basis is greater than the sale price. This tax position would possibly allow the contributing seller's to shelter other real estate gains or carry forward a net operating loss. In the absence of a corresponding tax liability, relatively illiquid OP units are less attractive compared with cash and stock.

No Significant Tax Impact

A neutral tax position, like a taxable loss, effectively removes a tax-based currency preference. Cash and stock are likely to be more attractive in this case, relative to OP Units, due to their enhanced liquidity.

Valuation

Previously, we looked at a contributing seller's tax position. The next step is to evaluate the contributing seller's portfolio. In our examination of portfolio valuation we will discuss three components: management, assets, and management contracts.

Management

How well is the company run? In the current cycle, REITs have sought to aggressively acquire privately held assets. Early in the cycle, REITs were focused on the assets, not the management. REITs were concerned more with growth than asset management. The market capitalization of the entire industry was only $8 billion in 1990, as opposed to $160 billion today[12]. According to Scott Tully at AEW, as REITs have grown, they have placed greater emphasis on acquiring good managers. Today, if a contributing seller possess both high quality management, and solid assets, this will probably be reflected in favorable transaction terms for the seller.

Assets

A contributing seller should identify the location, quality, size, type, and characteristics of the real estate assets to be contributed to the REIT partnership. We assume that the reader is familiar with the process of analyzing the basic qualities of a portfolio of assets in preparation for a real estate transaction.

Management Contracts

Management contracts are assets of the management company. In a real estate transaction involving a contributing seller and a REIT, where should the value of these contracts be allocated? Each party has a different perspective.

Due to tax laws, management income is problematic for REITs. At least 75% of the value of a REIT's income must consist of real estate assets, cash, and government securities.

> When REITs buy management companies, all sorts of technical tax issues arise. The revenue of the management company is considered bad REIT income. So a whole analysis has to be done to see if the REIT is willing to take on that particular level of bad income or whether we can structure around that issue by in some circumstances forming a taxable subsidiary. But you get into a host of complicated issues in terms of revenue.[13]

From the contributing seller's perspective, the owner may be able to pocket transaction funds from equity investors if the management company was not considered in the original equity investment. The general partner may argue that the sale proceeds reflect the value of both the management company and the assets, but in the absence of clear documentation, the equity owners may object to recognizing any value for the management company.

For example, a private contributor not only contributes his assets to the REIT, but his management company as well. The REIT agrees to pay $100 million dollars for everything. The private contributor has partners in his asset portfolio, but he may not in his management company. He may argue the management company is worth $25 million and would then only have to distribute $75 million to the asset partnerships. The asset partners would not be eligible to receive the sum apportioned to the management company provided they had not invested in the entity. Therefore, many equity partners insert clauses to protect themselves if they have invested in the management company during the partnership. Resolving allocation issues is a business decision involving the contributing seller's partnership, and not the REIT.

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[12] "NAREIT Annual Market Capitalization", NAREIT Document on Demand #211, June, 1998

[13] Interview with Minta Kay, Goodwin, Procter, and Hoar, Boston, MA June 16, 1998.

> In terms of allocation, typically what our documents say, and it is not terribly different from dealing with non-management companies. Typically, what we say is, Mr. Seller Partnership, we don't want to be involved in your allocation. We don't want to have to assure ourselves that you are telling us the units are flowing out in the proper number. We don't want to be responsible for calculating that, we want you to write down Mr. A gets X, and Mr. B gets Y shares and we want disclaimers on all of those documents that we are entitled to rely on that fully. So the REITs will basically say, you tell us what you want to do, we don't want to have anything to do with whether you [Mr. Seller Partnership] are doing it right or not.[14]

REIT Asset Pricing

How do REITs price private real estate portfolios? The REIT, through the OP unit investment vehicle, offers contributing sellers the opportunity to defer taxes. In other words, the REIT brings the opportunity to defer taxes to the bargaining table. An interesting question is who claims the value of that tax deferral? Capturing the value of tax deferral is a function of market dynamics and the pricing strategy of the particular REIT, both of which are subject to change.

As with a traditional private transaction, certain types of portfolios will be more attractive to certain REITs than others. At the beginning of the most recent REIT acquisition cycle, the market rewarded sharpshooters, or REITs, which focused on a particular product type in a specific geographical region. Then, REITs were rewarded for expanding their holdings by region and even product type. The REITs' appetite for asset growth has translated to REITs paying a premium for assets, see Example 2-1. Naturally, it behooves a potential contributing seller to understand the changes taking place in the REIT industry and their impact on pricing.

Currency Option Evaluation

In a REIT transaction, a contributing seller has the option of receiving three different types of currency: cash, stock, or OP units, or a combination thereof. Given different characteristics of each currency, evaluating the contributing seller's tax position is crucial in order to select the best possible currency combination. This section focuses on currency issues from the

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[14] Ibid.

perspective of the contributing seller. First, each currency option will be explained, then currency combinations and related issues will be addressed.

Cash

Receiving cash is relatively straightforward. This is a taxable event, triggering a tax liability on capital appreciation and deferred gain. Cash allows the greatest flexibility in terms of consumption and investment. However, investors are subject to reinvestment risk.

Stock

In exchange for contributing assets to the Operating Partnership of a REIT, contributing sellers may receive stock in the REIT. By receiving stock, the contributing seller now has an ownership stake in the company and has made an investment. Stock is issued by the REIT when the contributing seller contributes the assets to the operating partnership. In exchange for issuing stock, the REIT receives additional units in the operating partnership. Given the attention of analysts as part of the scrutiny of public markets, issuing additional REIT shares raises the issue of dilution in value to the existing shareholders (i.e., when the value of the outstanding shares drops after the new equity is issued by the REIT).

Dilution may occur if the market feels the REIT has over paid. Dilution raises two issues for the contributing seller. First, since the contributing seller will be paid in stock, the price of the stock may fall if the market reacts unfavorably to the transaction in terms agreed to by the REIT. Second, the contributing seller, as a shareholder, faces the possibility of dilution as a result of future transactions by the REIT. Dilution concerns factor in the REIT's consideration of which currency combination is best for the REIT. For example, if the REIT believes their stock is undervalued, they will prefer not to issue new stock.

We will now examine the positive and negative aspects of receiving stock in a REIT transaction from the perspective of the contributing seller.

Positives

Receiving stock in the REIT offers the contributing seller the possibility to participate in stock appreciation. REIT stock returned 13.32% from 1993-1998.[15] Recently, the REIT industry has experienced a trend in mergers and acquisitions. In many cases, the stock of the company to be acquired rises following the announcement of the merger. Taking back stock permits the contributing seller to participate in stock appreciation following a REIT merger. In addition, accepting stock allows the contributing seller to maintain real estate investment exposure.

Receiving stock in the REIT offers the contributing seller potential diversification by asset class and location. For example, prior to a transaction, a contributing seller had an interest in downtown Boston class A office space. After the transaction, the contributing seller has an interest, through the REIT stock, in class A office space, and multi-family apartments on the East Coast.

Negatives

Like cash, receiving stock is a taxable event, triggering a tax liability on capital appreciation and deferred gain. REIT stock is less liquid than cash and other securities. Although float, the volume of stock traded, in the REIT sector continues to grow, REIT stocks are less liquid than many other types of stocks. Trading large blocks of REIT stocks takes considerable time, relative to other types of stock.

Risks

Owning REIT stock has several risks, including management risk, legislative risk, and loss of control. Like other stockholders, owners of REIT shares rely on the successful stewardship of the REIT by management. If contributing sellers are interested in taking back stock, do they have confidence in management? What is the track record of management? Has the contributing seller conducted due diligence on the management of the REIT?

[15] "Most Recent Summary Performance", NAREIT Document on Demand #201, June 1998

After the transaction, owning shares offers contributing sellers little control other than voting rights. One way to assert control is to gain a seat on the board of directors. Gaining a seat on the board has become increasingly difficult and is only a viable option if the contributing seller posses a large portfolio. These issues will be discussed in detail in a separate section within this chapter.

Owning REIT shares exposes contributing sellers to legislative risk. Although REITs have existed since the 1960's, they have become popular investment vehicles only recently. The Internal Revenue Service (IRS) tentatively approved a version of the UPREIT structure. The DownREIT structure and bottom dollar guarantees (discussed later) have neither been approved nor challenged by the IRS. Potential REIT shareholders should be aware that certain important tax questions remain unanswered by the IRS.

Types of Stock

Similar to other public companies, different types of REIT shares exist, including common, preferred, and convertible preferred. In general, common stock offers the highest risk, return, and liquidity relative to preferred and convertible preferred stock. Convertible preferred offers both the lowest risk and return.

> Currently, REITs run at about 30% to 40% leverage on balance. That's very unique in the sector. If you take preferred stock, you're one step behind debt, but ahead of all that equity, you might be in the 40% loan to value tranche.[16]

Contributing sellers that have the option of choosing among different types of stock should determine which part of the equity capital structure offers the best return relative to acceptable risk.

Convertible preferred stock offers the option of converting to common at a certain price. For example, you buy a share of convertible preferred stock for $10 and negotiate the right to convert to common stock once the price of a common share exceeds $12. Some REITs may only issue

[16] Interview with Scott Tully, AEW, Boston, MA, June 15,1998.

common stock. The possibility of the REIT creating a separate class or new type of security in order to close a deal usually requires a powerful contributing seller.

Operating Partnership Units

A significant number of equity REIT offerings have been structured as UPREITs. In the UPREIT structure, investors do not own REIT properties directly. Instead, they own a stake in an operating partnership, which in turn owns the properties. Operating partnership units are generally exchangeable on a one unit for one REIT share basis at the option of the unit holder. The principal reason for choosing OP units is that it allows contributing sellers to defer the tax liability they would otherwise face if they were to sell the properties for cash or swap the properties for REIT shares. The DownREIT partnership structure (discussed later in Chapter Four) allows REITs formed prior to the UPREIT to compete against this new financial innovation.

The transaction terms specify which segment of the REIT capital structure the OP units track, usually the common stock. It is possible to have the OP units track preferred stock, for example. OP unit holders receive dividend payments just like stockholders, with the dividends taxed as ordinary income. In the course of a transaction, the OP units are issued by the operating partnership when the contributing seller presents the assets. Usually, a period of time called a lock-up period prevents the contributing seller from converting the OP units to shares. Lock-ups will be discussed in greater detail separately. We will now discuss the positive and negative aspects of contributing sellers accepting OP units. Since OP units resemble stock in many ways, some of these points have previously been discussed.

Positives

The principal benefit to receiving OP units in a transaction is the opportunity to defer the contributing seller's tax liability. As with stock, the contributing seller continues to invest in the real estate sector, capture equity appreciation, and possibly diversify his investments. OP units provide both the contributing seller and the REIT flexibility.

OP units offer flexibility to the contributing seller due to their convertibility to REIT shares. Unless specified by the REIT, in the black-out or lock-out periods, contributing sellers may convert their OP units to REIT shares at any time. This fact allows the contributing seller to control the timing of his tax liability. Usually, OP units exchange for shares on a one to one basis. In the course of negotiating the transaction, a different ratio may be specified. Usually, REITs allow contributing seller to transfer their OP units to their heirs for estate planning purposes during the lock-up period. After the lock-out period, the contributing seller is free to transfer the OP units to other qualified parties. For several reasons, explained below, issuing OP units also offers flexibility to the REIT. The fact that REITs view OP units favorably relative to other forms of currency benefits the contributing seller during negotiations with the REIT.

The main benefit for the REIT of issuing OP units, as well as stock, is that the REIT avoids returning to the public markets for capital. If a REIT decides to make a secondary offering, the investment banks typically take a 5% fee. The issuing of debt by a REIT also has a cost, whether the debt is secured by assets, or unsecured. By issuing stock and OP units, REITs avoid the public capital markets, minimizing transaction costs.

OP units are issued by the Operating Partnership, of which the REIT is the General Partner. Since the REIT is not issuing equity directly, as is the case of stock, conferring OP units to the contributing seller is not documented on the REIT's operating partnership's balance sheet. Since issuing OP units is effectively an off balance sheet transaction, OP unit issuance receives less attention from analysts in addition to minimizing transaction costs. Analysts view the Operating Partnership in the context of the REIT and are more concerned with the overall pricing of the transaction as opposed to focusing on the minutiae of the OP units issued to the contributing seller.

Negatives

As with the positive benefits of OP units, many of their negative aspects are also similar to those of REIT shares, such as management and legislative risk. OP units confer no voting rights to their owner, therefore owners have no input into management decisions of the REIT, even if it effects their OP units. OP units are illiquid. At present, no secondary market exists for OP units. As previously mentioned, converting the units to REIT shares is a taxable event.

When OP units are exchanged for assets in a REIT transaction, the OP units continue to have a link, for Federal Income Tax purposes, with a specific asset. After the transaction, the contributing seller has little or no control over the asset. If the REIT sells the asset in the future, after the lock-out period, the contributing seller may face a tax liability equal to the amount of the tax liability deferred when the contributing seller received the OP units. From a technical standpoint, the real estate asset was exchanged from the contributing seller to the REIT for units, not sold. If the contributing seller has transferred OP units to an heir, the heir could face this tax liability.

Contributing sellers maintain a post-transaction connection with the assets they previously conferred. This connection has significant implications in case another REIT acquires the REIT that the contributing seller conferred assets to. If the Operating Partnership of the REIT being acquired is dissolved, then the contributing seller faces a tax liability. Most mergers and acquisitions do not lead to the dissolution of the operating partnership, however, contributing sellers should be aware that this possibility exists. Under Section 708 of the Tax Code, if more than 50% of profits and capital interests in the Operating Partnership change hands within a twelve month period of time, the Operating Partnership is technically dissolved, triggering a capital gains tax liability on the contributing seller's OP units. The tax liability is triggered regardless of the lock-out period. All the OP unit holders of the dissolved Operating Partnership would face a tax liability. From the standpoint of the contributing seller, one way to protect against a future tax liability resulting from the dissolution of the partnership would be to insert a make whole provision in the Contribution Agreement. Make whole provisions in the context of lock-out periods are described separately.

Example 3-4 (below) illustrates the differences in the tax benefits depending upon the currency selection. The contributing seller must analyze the positives and negatives of each form of currency and weigh them against the tax deferral benefits.

Example 3-4 Sensitivity Analysis on Based on Currency Selection

This example illustrates the Net Sales Proceeds at closing to the contributing Seller based on his currrency selection. The asset is assumed to be sold in the 30th year of the holding period, ten years after the property was refinanced. Being conservative, we assume that the tax liability on depreciation due at closing takes precedence over the liability on capital gains.

		All Cash And/Or Stock Outstanding Debt Repaid	Cash For Transaction Costs Outstanding Debt Repaid Balance in OP Units	Cash For Transaction Costs Oustanding Debt Assumed Balance in OP Units
Currency Received:				
Cash and/or Stock		$ 40,000,000	$ 19,016,327	$ 400,000
Operating Units		-	20,983,673	20,983,673
Debt Assumption		-	-	18,616,327
Sale Price		40,000,000	40,000,000	40,000,000
Tax Analysis:				
Sale Price		40,000,000	40,000,000	40,000,000
Adjusted Basis		11,076,923	11,076,923	11,076,923
Gain On Sale		28,923,077	28,923,077	28,923,077
Gain from Depreciation		21,923,077	21,923,077	21,923,077
Capital Gain		7,000,000	7,000,000	7,000,000
Tax Liability:				
On Depreciation		5,480,769	5,480,769	5,480,769
On Capital Gain		1,400,000	1,400,000	1,400,000
Total Tax Liability		$ 6,880,769	$ 6,880,769	$ 6,880,769
Deferred Tax Liability:				
Taxable Currency		N/A	19,016,327	400,000
Adjusted Basis		N/A	11,076,923	N/A
Gain On Sale		N/A	7,939,404	400,000
Gain From Depreciation		N/A	7,939,404	400,000
Capital Gain		N/A	-	-
Tax Liability Due @ Closing				
On Depreciation		5,480,769	1,984,851	100,000
On Capital Gain		1,400,000	-	-
Total Tax Liability Due @ Closing		6,880,769	1,984,851	100,000
Total Tax Liability		6,880,769	6,880,769	6,880,769
Less: Tax Liability Due @ Closing		6,880,769	1,984,851	100,000
Total Deferred Tax Liability		-	4,895,918	6,780,769
Proceeds Analysis:				
Sale Price		40,000,000	40,000,000	40,000,000
Less: Transaction Costs @ 1%	1%	(400,000)	(400,000)	(400,000)
Net Sales Price		39,600,000	39,600,000	39,600,000
Less: Outstanding Debt		(18,616,327)	(18,616,327)	(18,616,327)
Less: Income Taxes Due @ Closing		(6,880,769)	(1,984,851)	(100,000)
Net Sales Proceeds @ Closing		$ 14,102,904	$ 18,998,822	$ 20,883,673

Conflict of Interest

Control factors relating to acquisitions also raise the issue of price discrimination. An example of price discrimination is carefully described by Shapiro, Timmermann, and Zoller in their explanation of The Chateau / Roc merger. In July of 1996 two REITs, Chateau Properties, Inc. and Roc Communities Inc., announced their attention to merge. Subsequent to the announcement, Sam Zell's Manufactured Homes made an offer for Chateau.

> There is an inherent conflict of interest between OP unit holders who are motivated by tax timing considerations and REIT shareholders who seek to maximize their return while facing a radically different tax situation. Moreover, as was made clear in the Chateau merger, partners in the Operating Partnership are in an inferior position to the REIT shareholders in a bidding war. Since OP unit holders have no voting rights until their interests are converted into shares, they are in an inferior position in a takeover situation. While OP unit holders have the right to convert their OP units into shares, doing so requires recognition of the deferred gain.
>
> In addition to UPREIT tax issues, there are general merger and acquisition tax considerations. Generally speaking, if a merger (or acquisition) is accomplished via a stock swap, as the original Chateau-Roc deal was envisioned, this is a tax deferrable event. The gain between the book value of the original shares and the market value of the shares received as consideration will be deferred until the shareholders actually sell the new stock. However, if the merger/acquisition is on a cash for stock basis, this is considered a taxable event and the original shareholders will have to recognize the capital gain at the time of share conversion.[17]

Essentially, Zell made a cash offer to the Chateau shareholders at a higher price than the applicable conversion ratio for the holders of Chateau OP units into Manufactured Homes OP units, which benefited the Chateau stockholders at the expense of the OP unit holders, some of whom sat on the board.

[17]Marla Shapiro, Barth Timmermann, and Bonnie Zoller, "The Chateau / Roc Merger, A Trailer War Exposes the Conflicts Inherent in the UPREIT Structure", MIT, 1997

Chateau stockholders would have been better off accepting Zell's offer than merging with Roc. In the end, Chateau made a counter proposal, involving the conversion of a substantial number of OP units into shares, in order to retain a voting majority. In early 1997, Roc and Chateau definitively agreed to merge. The Chateau / Roc merger highlights the conflict of interest between OP unit holders and stockholders and the fiduciary risks involved.

Debt and Maintenance Agreements

In most transactions, the contributing seller's real estate asset or portfolio will be encumbered with considerable debt. In the course of a contribution transaction, the contributing seller's current debt on the asset (or portfolio) must be accounted for properly to avoid a tax liability for the contributing seller due to cancellation of debt. The contributing seller contributes debt and equity interests into the Operating Partnership. If the REIT extinguishes the debt, then it creates a taxable gain for the contributing seller. For IRS accounting purposes, the contributing seller's debt has to remain identified with him. If the contributing seller's debt is repaid as part of the UPREIT transaction, for tax purposes, such a repayment is deemed to be a taxable distribution to the contributing seller. Debt maintenance agreements and "bottom dollar" guarantees ensure that contributing sellers do not face a taxable gain, and a corresponding tax liability, as a result of contributing their assets to the Operating Partnership. These debt maintenance agreements also go by informal names such as "debt swap."

> There are often debt maintenance requirements as well that continue to apply post closing. Very frequently REITs will agree to maintain debt on properties for a period in case a contributor has negative capital accounts that need to be covered. They'll either do that by agreeing to maintain non-recourse debt that is on the property by means of assuming it or replacing the non-recourse debt by giving the contributor the right to issue bottom dollar guarantees.
>
> Bottom dollar guarantees are used to replace the extinguished non-recourse debt. The way they work is the unit holder will issue a guarantee of debt of either the UPREIT or the DownREIT. That will result in the allocation to them of a portion of that debt. It is recourse to them. It is a recourse guarantee issued by Mr. Smith of debt of the UPREIT or DownREIT. The guarantee however is one in which the actual exposure is nominal. It is a guarantee that kicks in only if the value of the property involved in that specific debt that is guaranteed drops in value below the actual guarantee. So if you issue a bottom dollar guarantee for $4 million dollars

> on a property with a $20 million dollar value, this is just a little slice of a much bigger piece of debt that is secured. The $20 million dollar property would have to come down in value $17 million dollars to $3 million to trigger a $1 million dollar guarantee obligation. So people get comfortable that the property value can fall, but the range is so huge that it will never get on the books. The bottom dollar guarantee is only on the specific properties secured by the debt and would not be affected by the other assets.[18]

In other words the REIT will allocate a portion of debt to the seller on the specific asset involved in the transaction. This allocation, or bottom dollar guarantee, is a recourse obligation based on value of property involved in the transaction. As indicated above, the exposure on a bottom dollar guarantee is small relative to the asset, thus carrying nominal risk for the contributing seller. The REIT may also assume the debt and agree to maintain the non-recourse debt in order to protect the contributing seller from a deemed distribution.

Positives

The assumption and continued maintenance of the debt by the REIT, and bottom dollar guarantees, allow the contributing seller to avoid a tax liability as a result of a contribution transaction. From an accounting standpoint, the contributing seller's name is still associated with the debt in order to avoid the tax liability. From a financial standpoint, the contributing seller is relieved from the debt obligations associated with the assets contributed to the Operating Partnership. The possibilities of debt assumption and bottom dollar guarantees provide the contributing seller and the REIT flexibility in structuring a contribution transaction.

Negatives

If a REIT (although technically the Operating Partnership) decides to assume or replace the non-recourse debt, it will be reflected on the balance sheet of the Operating Partnership. Replacing non-recourse debt raises the issue of the REIT's capacity to do so. It is generally easier for a large REIT to assume debt than for a small REIT. The contributing seller could face taxable gain and corresponding tax liabilities if the REIT decides to de-lever without a bottom dollar guarantee, as shown in Example 3-5.

[18] Interview with Minta Kay, Goodwin, Procter, and Hoar, Boston, MA, June 16, 1998.

Example 3-5 Ramifications of Debt being Extinguished

The property was sold in the 30th year of the holding period.
The REIT to assumed the outstanding debt as illustrated in the third and fourth scenarios of Example 3-4. The REIT was not required to maintain the non-recourse debt and a bottom dollar guarantee was not negotiated.

This example illustrates the tax liabilities to the contributing seller if the REIT decides to extinguish the debt four years from the date of the transaction.

Loan balance at transaction	$ 18,616,327
Loan balance four years later	15,786,496
Contributing Seller's Marginal Federal Income Tax Rate	39.6%
Contributing Seller's Tax Liability	**$ 6,251,452**

Legislative Risk

In contribution transactions, bottom dollar guarantees have neither been approved nor challenged by the IRS. Given recent IRS scrutiny of paired share REITs, and the REIT industry as a whole, the IRS view of the treatment of debt in REIT transactions may change. A new administration could easily calculate the lost revenue in taxes from these transactions and legislate away the tax deferred benefits available with bottom dollar guarantees.

Financing Risk – A Strategy to Receive Tax Free Cash

In theory, debt obligations such as bottom dollar guarantees offer contributing sellers a financing strategy. Before consummating the transaction, the contributing seller could borrow as much as possible against the asset. The REIT would step in, extinguish the debt, and issue the guarantee. The contributing sellers would receive cash prior to the transaction, tax free, with the refinanced loan. This could only be done with a REIT with sufficient cash reserves to extinguish the debt, or one willing to participate in a secondary offering to raise cash. This second scenario is less likely given our previous discussion on the transaction costs involved with an equity offering. This strategy is risky since the IRS could, with justification, argue that the transaction was a disguised sale. In this case, the contributing seller would face a large tax liability. We only offer this as one potential strategy that could be pursued by a contributing seller.

REIT Evaluation

A Brief History of REITs, Their Market Acceptance-Capitalization-and Returns

The U.S. Congress created real estate investment trusts in 1960 to allow the average investor the opportunity to invest in real estate. The mutual fund industry was the model for the REITs' beginning. However, the REIT investment vehicle was little used by the public. REITs were only allowed to own the real estate, and had to hire outside management to operate the properties. Further, the tax structure of the day allowed for the substantial sheltering of losses in real estate from direct investment. REITs do not allow taxable losses to pass through to their shareholders. The REIT structure was clearly at a disadvantage in terms of competing with the direct investment of real estate. By the end of 1985 the market capitalization for all REITs was only $7 Billion.[19]

Two tremendous changes occurred in real estate due to the Tax Reform Act of 1986. First, REITs were permitted to operate and manage their owned assets. Second, and perhaps more importantly, the generous tax sheltering features in direct ownership of real estate were curtailed. Change in REIT investment was slow in coming; the late 1980's were a period that had banks and institutions making large quantities of real estate loans for developers. The market capitalization of all REITs in 1990 remained low at approximately $8.7 billion.[20] The ensuing real estate recession, a thesis on its own merits, aided the real estate decline of the early 1990's. This was a period of low property values compounded by a drought in the availability of private capital from local and institutional sources.

While the series of events that led to the economic conditions in 1992 could be debated, the fact remained that access to public capital was now a very attractive option for real estate owners. The addition of the UPREIT structure created tax advantages for the original owners of the private real estate assets. The influx of public investment has been dramatic. The number of REITs has increased from the 62 in 1985 to 215 as of June 1998 with an overall market

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[19] "NAREIT Annual Market Capitalization", NAREIT Document on Demand #211, June, 1998
[20] Ibid.

capitalization of about $160 billion.[21] The sheer volume of investment has demonstrated the acceptance of the REIT instrument in the marketplace.

As seen in Table 3-1 REITs have returned nearly 13% over a twenty-year period and 19% over the past three years, including an unheard of 35% in 1996.[22] While the REIT sector is off between 10% and 15% this year, investors are aware of the long term returns and sophisticated investors do not expect to be able to maintain the returns of 1996 and 1997.

Additional positive signs for the REIT industry are based on the percentage growth of the public real estate sector. It is estimated that real estate in the United States is approximately a $4 trillion market. As of 1997, the public sector only accounted for between 3% of the industrial and office markets to 5% of the multi-family and hotel markets. Estimates are that by 2002 roughly 12% of the market will be publicly owned,[23] or $480 billion, an increase of more than $300 billion over today's levels.

Table 3-1: NAREIT Total Return Indexes

	For Period Ending June 30, 1998									
	1 Month	3 month	6 month	Year to Date	1 Year	3 Year	5 Year	10 Year	15 Year	20 Year
All	-0.62%	-4.63%	-5.15%	-5.15%	6.39%	18.88%	13.32%	10.11%	9.81%	12.91%
Equity	-0.68%	-4.59%	-5.03%	-5.03%	8.05%	18.99%	13.22%	12.21%	12.97%	15.54%
Mortgage	1.03%	-3.52%	-0.74%	-0.74%	-8.34%	23.50%	15.71%	6.93%	5.55%	8.55%
Hybrid	-1.94%	-7.24%	-13.65%	-13.65%	-8.16%	10.73%	10.83%	6.01%	7.07%	11.29%
S&P 500	4.06%	3.30%	17.72%	17.72%	30.17%	30.22%	23.04%	18.53%	17.22%	17.41%
Russell 2000	-0.54%	-5.38%	4.21%	4.21%	15.71%	18.58%	15.89%	13.50%	11.05%	N/A

Contributing Seller Strategy

The contributing seller must understand the long term significance of transacting with a REIT. This chapter emphasizes the point that a contribution is not a one time sale; rather, it's a long term investment in a public company. The contributing seller should decide an appropriate strategy for his REIT investments, including whether to maintain concentrated or diversified

[21] Ibid
[22] Ibid
[23] Timothy Riddiough , "Real Estate Capital Markets Course Notes", MIT, Spring 1998

holdings. Holding a small-capitalized REIT's stock versus a large capitalized REIT's stock should be evaluated.

The contributing seller may elect to make an investment in a smaller REIT. It will allow the contributing seller to capture the potential returns from the smaller REIT's faster growth as compared to a large cap REIT's growth. Investing small amounts into several REITs could satisfy a diversified approach, and remove the unique risk of holding a single REIT's stock. This could be accomplished by contributing assets to several REITs or by investing cash received in the transaction in other REIT stocks.

There are positives and negatives to investing in either a large cap versus a small cap REIT. Larger REITs have less opportunity to experience stock price appreciation through growth opportunities. Smaller cap stocks may be able to double or triple in size, giving early investors an opportunity to achieve a return based on their growth potential. In contrast, large cap REITs have already acquired a substantial portfolio making it difficult to support the same percentage level of growth. Larger cap stocks may be traded by institutional investors, creating a larger daily float and thereby a more liquid currency. REIT stocks in general trade at much lower volumes than other public companies of similar size, so a large block of small cap stock could take months to unload. Given the contributing seller's amount of portfolio debt, small cap stocks may not be in a position to assume the full amount of contributed debt and provide bottom dollar guarantees. A comparison of large versus small-capitalized REITs is found in Table 3-2.

Table 3-2 Comparison of Small Cap vs. Large Cap REITs

	Small Cap REIT	**Large Cap REIT**
Percentage growth potential for REIT	Positive	Negative
Stock price 'Pop' when assets are contributed	Positive	Negative
Potential for Board Seat	Positive	Negative
Greater leverage in covenant negotiations	Positive	Negative
Daily float & greater liquidity	Negative	Positive
Debt assumption capabilities	Negative	Positive
Likelihood of portfolio diversification	Negative	Positive

Due Diligence

The professional advice that the seller receives, discussed in Chapter Four, assists the due diligence process. However, the contributing seller should be aware of the issues involved in selecting an appropriate REIT. As seen in the REIT Roadmap in Appendix 1, a transaction could be stifled if negative issues are revealed by due diligence on a specific REIT. The REIT's management team, strategy, track record, capital structure, and portfolio all require appropriate investigation.

The contributing seller needs to investigate the management team of the REIT, analyzing their experience level, not only in real estate, but also in running a public company. The REIT should be able to answer the questions; What is your strategy?, Do you make investments that follow this strategy?, What differentiates you from your competition? The investment track record of the REIT will reveal if management has made positive net present value investments and performed according to it's plan, or if they have not been meeting their goals.

REIT capital structure is significant. Unsecured debt levels typically range from 30% to 40% of the market capitalization of the REIT. It is recommended that the contributing seller determine how analysts feel about the debt level of the prospective REIT. If analysts believe that the REIT has too much debt, the REIT's stock price may suffer. In a more extreme case, excess debt could cause the REIT's debt rating to be affected, lowering the REIT's stock price as well as increasing the cost of borrowing capital.

Control Provisions

The Lock-Out Period

The contributing seller will negotiate a period of time during which the REIT will agree not to sell the contributed assets for a specific timeframe (the "lock-out" period). This timeframe is the length of the tax-deferred benefit of the transaction. The contributor will negotiate such a period based on his tax liabilities on each asset.

REITs typically maintain options in the event that they do want to dispose of an asset, including the right to conduct a 1031 exchange with a contributed asset. 1031 exchanges are reviewed in Appendix 3. The REIT will also typically maintain the right to violate the lock-out; however, the REIT must make the contributing seller 'whole' if the REIT decides to sell the asset and violate the lock-out period. Specifically, the REIT must compensate the contributor for the lost period of tax deferral. The REIT will typically pay a negotiated return on the amount of money that the contributor has to pay early in taxes. The return will be based on the time period from when the contributor had to pay the tax to the end of the agreed lock-out period. In nearly every case, however, the REIT will not pay the actual tax liability of the contributing seller. If the contributed asset (portfolio) is small, the contributing seller could negotiate that the REIT will lend it the money (at a low interest rate) to actually pay the taxes. Certain smaller contributors are wary that they may not have the funds to pay the taxes in cases of large tax liabilities.

Typically, REITs are paying a hypothetical return on the money that had to be paid on a tax payment prior to the end of the lock-out period. The return is based on what the contributing seller would have earned in an investment. This clause is referred to as the Liquidated Damages Provision and according to Kay is negotiated "very clearly as the sole and absolute remedy for the contributing seller if the REIT elects to violate" the lock-out period. Example 3-6 provides an illustration of a 'make-whole' provision.

At the present time, REITs are not typically selling assets. To the contrary, REITs are giving longer lock-out (tax deferral) periods as they compete in the marketplace for assets. They do not have the intention to sell so they are willing to place greater restrictions on their portfolios. This could be short sighted given possible changes in market conditions or tax policy. For example, if the REIT has a $700 Million market cap after a $300 Million acquisition, 3/7$^{\text{ths}}$ of the asset base are frozen from future transactions. When lock-out periods were first utilized they ranged from three to five years. According to Kay, REITs have been recently averaging between seven to twelve years. In fact, a REIT recently offered a twenty-year lock-out period and another REIT is considering a permanent lock-out period for a specific transaction.[24]

Example 3-6 Make Whole Provision

This example illustrates the calculation of a make whole provision. The contributing seller needs to be compensated for the lost investment income on the deferred tax liability from the time he was required to pay the taxes to the end of the negotiated lock-up period.

In addition to deferral value (investment income), the contributing seller must be compensated for the federal income tax liability he will realize when he receives the Make Whole payment from the REIT.

This example assumes that the REIT sold the contributed assets four years from the time of the original transaction, with three years remaining in the lock-up period.

The calculation is based on the contributing seller's expected rate of return of 10%. This rate would be negotiated for inclusion in the contribution agreement.

Make Whole Provisions vary for each transaction. This example is meant only to provide the reader with a basic understanding of the make whole payment calculation.

Make Whole Payment Calculation:	
Lost Deferral Value (Investment Income):	
Deferred Tax Liability, from Example 3-4	$ 6,780,769
Less: Present Value of Tax Liability if Paid at End of the Lock-Up Period - 3 years @ 10%	($5,094,492)
Make Whole Payment for Lost Investment Income	**1,686,277**
Calculation to Include Federal Income Tax Liability:	
Divide Lost Deferral Value (Investment Income) by (1 - Ordinary Federal Income Tax Rate)	0.604
Make Whole Payment	**$ 2,791,849**
Breakdown of Make Whole Payment:	
Make Whole Payment	$ 2,791,849
Federal Income Tax Rate	39.6%
Portion Allocable to Federal Income Tax Liability for the Contributing Seller when REIT Provides Make Whole Payment	1,105,572
Portion Allocable to Lost Deferral Value (Investment Income)	1,686,277
Total Make Whole Payment to the Contributing Seller	**$ 2,791,849**

The Lock-Up Period

The REIT usually requires that the contributing seller agree to period of time in which he will not be able to convert OP units into shares (the "lock-up period"). Many investment banks advise that it would not be in the REIT's best interest if large blocks of OP units were immediately

[24] Interview with Minta Kay, Goodwin, Procter, and Hoar, Boston, MA, June 16, 1998.

converted into stock and then sold on the market. Accordingly, REITs require that the contributor be unable to convert the units for a specified period of time. This is one of the more heavily negotiated provisions in respect to the time and terms of the agreement. A common misperception is that the lock-up period is required by Security Exchange Commission (SEC) regulations. The SEC does not stipulate that lock-up periods are mandatory. It is a control provision that the REIT requires in these transactions. At the time of this writing, the typical length of a lock-up period is approximately twelve months.

The Black-out Period

Under Federal securities laws, there need to be periods in which the contributing seller cannot sell his shares in the marketplace. If the REIT has possession of material non-public information--it is about to complete a secondary offering or buy a portfolio, for example--it cannot have the OP unit holders converting their shares in the public marketplace. Conversion at this time could create shareprice volatility possibly affecting the transaction. In order to sell, the OP unit holders need to sell based on a current prospectus. If a REIT does possess such material non-public information, the last prospectus on file is no longer accurate. Black-out periods are negotiated to protect the REIT and its investors. There are a variety of periods that are available for discussion between REITs and the contributing seller. Some REITs have many black-out periods for thirty day time frames; others will have two for a ninety day period. Each REIT will have its own preferences.

A Board Seat for the Contributing Seller

Certain contributing sellers require a seat on the board of directors in an attempt to maintain some level of control over their portfolio. While this requirement was more common in REIT initial public offerings, it is still seen today. To even attempt to gain a seat the contributing seller must be adding at least 10% to 15% to the total current market capitalization of the REIT.

Provided the contribution of assets is significant, the board will consider the possibility of admitting another board member. According to an attorney familiar with these transactions, it depends on how the board feels about the developer contributing the assets. Further, as REITs mature and grow in market capitalization, there may not be room on the board. Provided that the board is willing to allow a new member, REITs cannot simply grant the request as part of the negotiations. REITs do not have the authority to grant the seat themselves. Rather, they agree to put the contributing seller up for a vote by the stockholders. REITs would time the vote to occur just prior to the closing date of the transaction, provided that the director seat was a condition to close on the transaction. Typically, whoever is put up for a vote does get elected; it is not, however, guaranteed.

The contributing seller should carefully consider the option of taking a board seat, if it is available. It may not be worth the contributing sellers' time given certain risk aversion levels. There are many legal issues involved and obligations in connection with being a director of a company. First, you must look after the best interests of the broader shareholder base. You cannot necessarily make decisions based on the optimal value of your stock portfolio. Your fiduciary responsibility lies with the stockholders. There are more restrictions placed on the rights of board members to trade their stock by the SEC. This further decreases the liquid nature of the shares or OP units of the contributing seller.

As a board member, the individual is open to liability issues. Law suits against board members are not uncommon. The contributing seller must decide if he wants to run the risk of legal action. AEW Capital Management has advised certain clients that the board seat will not provide enough benefit given the risks involved. A client of Goodwin, Procter, and Hoar sought a board seat and had the REIT put him to a vote of the shareholders. The REIT agreed and tried to get him on the board. At the time the contributing seller was elected, the board seat was not in his best interest, since the board seat presented too many liability issues. It is clear that the contributing seller should seek advice when contemplating a board seat.

Management Participation for the Contributing Seller & Staff

A contributing seller may maintain some input in the management of his former portfolio without joining the board of directors. Certain transactions have been negotiated to include an asset management component. This allows sellers to maintain an interest not only for themselves, but also for staff members that have remained loyal to the original company. The Baur Properties transaction with Duke Realty is an illustration of this transaction component. As stated in the case study, Mullins maintained a position with Duke. However, the staff of less than twenty that had been dedicated to Baur was able to transfer their jobs to Duke. This was one of the motivating factors for Baur and why Duke was chosen as the purchasing REIT. This option will not be available for every asset contribution. However, depending on the portfolio size and the REITs in the bidding process, an element of control over one's life's work is possible to maintain.

Depreciation Control

The method of depreciation is another heavily negotiated issue in the transaction. While the contributing seller's tax advisor should be involved with the legal team, it is important that the seller be aware of this issue. After the transfer of assets to the REIT, the contributing seller will need the method of depreciation to remain similar to the past, given his tax position. If the REIT were to depreciate the assets in a different manner it could trigger tax liabilities to the contributing seller. This clause will control the tax basis of the assets going forward.

The REIT Structure Going Forward

One last aspect to consider as a contributing seller is that the REIT may amend the Operating Partnership agreement at some point in the future. This could negatively affect the contributing seller. The REIT will need to gain consent of a specific percentage of sellers in order to change the original agreement. This percentage will be included in the contribution agreement, which will be discussed in Chapter Four.

Summary

Despite the control issues discussed above, it is critical for the contributing seller to realize that he will have a small percentage of the control he had previously over his portfolio. Goodwin, Procter, and Hoar suggest to their clients that they envision the contribution process as an outright sale of their assets. The contributing seller, in point of fact, has little post-transaction control.

Post-Transaction Activity

Gaining Liquidity with a Loan on Stock and Operating Units

There are options available to the contributing seller after the contribution transaction has closed. For example, it is possible to borrow against the value of the OP units. This allows for liquidity without the tax liability of converting the units into stock. Similar to borrowing against as stock portfolio, however, lending institutions will only lend on a percentage of the unit value. According to an analyst at AEW, if there are no restrictions on the OP units, lenders familiar with OP units will typically lend up to 40% of the OP unit portfolio value. An associate at First Union stated that his bank, under certain circumstances, would lend up to 75% of the value of the OP unit portfolio, if the borrower had a long-standing relationship with the bank. Certain sophisticated investors have negotiated agreements with REITs to place collars on the value of the OP units (e.g., the price will never drop below eight, but the contributor will never realize a gain above twelve). An analyst at AEW estimates that collars allow the contributing seller to lend against the guaranteed lower collar of the units of up to 90 % of the portfolio. In our example, since the OP units are guaranteed to never drop below eight, a lender would lend up to 90 % of the put price of eight, or $7.20 per OP unit. Potential contributing sellers should be aware that, to date, only large institutional sellers with tremendous bargaining strength have negotiated collar agreements.

Secondary Operating Partnership Unit Fund

AEW Capital Management is in the process of beginning a fund for OP unit holders. The purpose is for holders of units to contribute their units in exchange for units in the overall fund. This will be similar to a mutual fund concept. The fund unit will be more diversified (less volatile) than the specific unit tied to the REIT. The fund unit would then be able to be used as collateral to secure a loan. The less volatile unit will allow fund unit holders to borrow greater percentages of cash based on the portfolio value. This will tap into the estimated $15 billion in OP units currently held in the marketplace and allow contributing sellers without substantial transaction leverage at the REIT level to negotiate a collar agreement and gain the ability to liquidate a larger percentage of his portfolio.

Chapter Four: The Legal Structure of REITs, Documentation, and Representation

There are three types of REIT variants: REITs, UPREITs, and DownREITs. In order to offer contributing sellers the ability to defer taxes, existing (non-UPREIT) REITs created DownREIT partnership structures for individual transactions. UPREITs are REITs that originated with an umbrella partnership. We will now examine UPREITs and DownREITs in detail and discuss their common points and differences

UPREIT

In order to qualify as an UPREIT, a REIT must include an umbrella partnership to hold title to the assets and liabilities. Each new transaction is consummated as an addition to the Master (Operating) Partnership. The REIT is the general partner of the Master Partnership. Contributing sellers contribute their assets on a tax deferred basis. The dividend received by investors, including contributing sellers, reflects the performance of all the assets in the Master Partnership. In other words, the dividend includes all the assets of the UPREIT, not just the assets donated by the contributing seller. Thus, a contributing seller receives an often significant measure of diversification. The UPREIT structure has become widespread: of the 100 largest equity REITs, 67 are organized as UPREITs. OP units outstanding for REITs were valued at approximately $12 billion at the end of 1996, or about 13 percent of the nearly $100 billion of implied total market capitalization of all REITs.[25]

DownREIT

Older REITs, formed prior to 1992, do not posses umbrella partnerships and, therefore, cannot offer the tax deferral benefits to contributing sellers that UPREITs can. For these REITs however, the use of a DownREIT structure creates similar advantages to those of UPREITs. Using DownREIT units preserves the prior owner's tax basis in the assets. The structure of the DownREIT mimics that of an UPREIT to a large degree. The principal difference is that there is not a single partnership that holds all the REITs assets, but each contribution of assets to the REIT entails the formation of a new and distinct partnership. The REIT creates a separate

DownREIT for each transaction, instead of adding to an umbrella partnership in the case of an UPREIT. For each transaction, a new Partnership Agreement needs to be negotiated. The REIT, or a qualified REIT subsidiary is the general partner, and the contributing seller is the limited partner.[26] The REIT, as general partner has complete operating control. The DownREIT structure allows conventional REITs access to what was previously regarded as the UPREIT's competitive advantage. Unlike an UPREIT though, substantially all of the REIT's assets are not in the DownREIT.

The limited partner in the DownREIT is usually required to hold the DownREIT units for a minimum of one year or more (the "lock-out period") before having the option to exchange the units for shares. The exchange value of DownREIT units into shares is generally set at or about the market price of the REIT shares at the time of the transaction. The DownREIT versus the typical UPREIT allows for more flexibility in the payment of distributions on units. Because each transaction involves a separate partnership, there is no need for homogeneity of distribution payments on units. On the other hand, an UPREIT may, to some extent, create flexibility by issuing more than one class of OP units.

The typical DownREIT structure is to have an existing REIT form a partnership wherein the contributing seller donates his assets (and liabilities) in exchange for equity units and the REIT contributes cash, which is used to pay off certain debt on the donated assets. The equity units are valued according to the respective contributions of cash and/or real property equity that each contributing seller donates. The following is an example of a DownREIT executed by Pacific Gulf Properties:

> It was through a long-standing relationship with southern California developer John Konwiser that, early in 1995, we found an opportunity for doing a DownREIT. Mr. Konwiser headed a consortium of 11 apartment projects in five southern California cities: Covina, West Covina, Diamond Bar, Ontario, and San Dimas. There were a total of 1,368 units in these properties.

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[25] "Industry Overview", Real Estate Investment Trusts, 1.02[4][c]
[26] Ibid.

> We saw that this would be a complex transaction because approximately 70 partners in 17 different partnerships owned the 11 properties. The first transaction took a year to put together. We signed an agreement to acquire all of the properties for about $72 million. We then formed a new operating partnership in which Pacific Gulf Properties would own 80% and become the general partner with the members of the consortium all becoming limited partners and holding a 20% interest.
>
> In mid-August, we announced that escrow had closed on eight of the 11 projects, with a total value of $63 million. A few days later, we closed escrow on the last three properties, valued at $9 million. At these closings, Pacific Gulf issued a total of 226,000 limited partnership units [similar to OP units]. These units are convertible into Pacific Gulf common stock on a one-for-one basis beginning in August 1997.
>
> Our company will invest a total of $14.5 million in the operating partnership. Of that total, $13.5 million will be used to pay down and restructure conventional debt on a portion of the portfolio and costs associated with consummating the transaction. The remaining $1 million will be used to improve the properties over the next year or two.
>
> After the company has received a stated fixed return on its investment, the limited partners will receive a cash distribution (to the extent that the partnership has cash to distribute) equal to the Pacific Gulf's dividend per share for each partnership they hold. Thus, in a single transaction, Pacific Gulf increased its assets to $280 million, more than double what they were less than two years earlier.[27]

Economic Difference between an UPREIT and a DownREIT

Generally, the economics of a DownREIT are intended to mirror those of the UPREIT. DownREIT dividends track off of what the particular portfolio exchanged by the contributing seller produces, as opposed to UPREIT's where the dividends track the entire portfolio. REITs with the DownREIT structure have attempted to remedy this situation in order for contributing sellers to have the same economic and diversification benefits. A preferred return is negotiated to approximate the dividend paid to the REIT shareholders. This return is usually negotiated as a flat percentage basis, although some deals have used increases based on the Consumer Price Index (CPI). However, these types of preferred returns create a tax tension. The closer the REIT matches the exact dividend, the more likely the tax deferral benefit of the entire transaction will

[27] Glenn L. Carpenter, "DownREIT Strategy", NAREIT Legal Issues, June 1998.

be voided. There is a lot of discussion in these transactions about what the preferred return will be. This is not an issue with an UPREIT.

Advantages of DownREITS over UPREITS

The principal advantage of a DownREIT is the ability to tailor a transaction unique to the contributing seller. In an UPREIT transaction, the contributing seller has to be accommodated by the original Partnership Agreement. In a DownREIT transaction, the partnership units may be customized at the time of a particular transaction so that exchange values and other particularities unique to each asset may be taken into account.[28] Variables include an exchange value above market and a longer period of time before conversion. These variables are also shared with UPREITs. A priority return of cash distributions to the REITs is an example of a variable unique to DownREITs.

One way in which a DownREIT can be considered an improvement on the UPREIT is in the elimination of certain conflicts of interest. As previously mentioned, there is an inherent conflict of interest in the UPREIT structure in that the original contributing sellers, or sponsors, form the majority of the management team as well as holding the bulk of the OP units. The DownREIT avoids this conflict to some extent by avoiding the overlap of management and limited partners. In a typical UPREIT, the incentive may exist for a REIT officer or director to sacrifice the good of the REIT for his own financial well being. In a DownREIT transaction some limited partners may be accorded the right to restrict dispositions and refinancings, creating tension between OP unit holders and REIT shareholders. However, it is arguable that the degree of conflict of interest is more severe in the case of the UPREIT than DownREIT.[29]

Disadvantages of DownREITs Relative to UPREITS

DownREITs are cumbersome in terms of documentation. A REIT that forms several DownREITs to accommodate a variety of contributing sellers must create a separate set of financial and legal documents for each transaction, costing time and money.

[28] "Industry Overview", Real Estate Investment Trusts, 1.02[4][c]
[29] Ibid.

> These [DownREIT] transactions are more cumbersome from a documentational point of view, in terms of getting things done. In the UPREIT transactions, from a documentational point of view, you sign on to the master limited partnership. You can negotiate little pieces around the fringe, but nothing significant. You accept the UPREIT's standard form in a registration rights agreement.[30]

Since all transactions between contributing sellers and REITs are complex, requiring the expertise of a variety of professionals, the increased costs may be significant. Outside analysts will also require more time to study more complex transactions.

DownREITs also entail legislative risk. The DownREIT vehicle has yet to be sanctioned by the IRS. A change in the tax code, or a challenge to the DownREIT vehicle is a potential risk. Finally, a high degree of leverage may also pose challenges for a DownREIT transaction, as explained below.

> A couple of cautionary notes: In structuring a DownREIT, great care must be taken to avoid diluting the equity of the REIT's existing shareholders. It is also essential to avoid too much leverage on a transaction. Highly leveraged projects may not provide enough room to do a DownREIT; in some situations it might not be possible to restructure the debt without putting in more money than the property is worth or triggering a tax liability to the contributing seller.[31]

Table 4-1 Comparison of DownREITs and UPREITs

	Advantages			Disadvantages		
	Defer Tax	Diversify	Provide Flexibility	Conflict of Interest	Conversion To UPREIT	Legislative Risk
UPREIT	yes	more	less	more	non-issue	less
DownREIT	yes	less	more	Less	Difficult	more

Converting a DownREIT to an UPREIT

Converting a DownREIT to an UPREIT is expensive due to transfer taxes. The conversion process entails dismantling each separate DownREIT partnership agreement as well as the REIT in order to transfer the assets to the new REIT with a master umbrella partnership. This triggers a transfer tax. Certain states, such as California have high transfer taxes. The REIT's board of

[30] Interview with Minta Kay of Goodwin, Procter, and Hoar, Boston, MA. June 16, 1996.

directors must weigh the cost of converting the REIT to an UPREIT versus the benefit of future acquisitions due to the UPREIT status.

Documentation

This portion of the thesis is meant to familiarize the contributing seller with the basic legal documents involved in a contribution transaction. While general counsel will be responsible for drafting these documents it is our opinion that the individual seller should be familiar with the process.

The Contribution Agreement

The master document in a contribution transaction with a REIT is called the contribution agreement. Every exhibit will be attached to, and all materials that need to be signed will be included with this document.

> This is really the framework for the entire transaction. It tells the story of how the property will be contributed into the REIT and what the nature of the tax deferral period will be.[32]

This document is where the UPREIT or DownREIT partnership agreement will be found. The Contribution Agreement informs the REIT when it has the right to resell the property and explains to the contributing seller all of his rights and obligations. The specific lock-out and lock-up clauses are listed in this portion of the closing documents.

If a contributing seller is attempting to gain a board seat, the provision, which places him before the stockholders for a vote, is placed in the agreement. The contribution agreement will also have a negotiated clause where the REIT will want the contributing seller to maintain all past records for the subject properties.

> The reason [for this records clause] is that the REIT needs the ability to go and audit those books for the purpose of securities filings that they have to make on an ongoing basis. Some contributing sellers are starting to focus on this clause and saying that they will not pay for this. 'Here are my books and records, you can do

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[31] Ibid

[32] Interview with Minta Kay, Goodwin Procter and Hoar, Boston, MA, June 16, 1998

> what you want with them, you pay for the audit.' Currently the dollars in the long run are not that high and some sellers are writing them off to transaction costs.[33]

The Contribution Agreement contains strict confidentiality provisions. It is fundamental for REITs and other public companies not to have information leak into the market. This section of the agreement will give the REIT the control of the content and timing of any press releases. As Kay illustrated, "The REITs do not want the sellers going out into the marketplace saying, we just got a great price, and the REIT overpaid." This is not beneficial for the REITs stock value, and could even hurt the contributing seller value if he took OP units or stock.

Prospective Subscriber Questionnaire

Anyone related to the contribution of assets that is going to receive stock or OP units must sign a securities document called the prospective subscriber questionnaire. Securities laws require the recipients of OP units or stock to be "accredited investors". There are income, net worth, and financial sophistication tests to establish if an individual or entity is an accredited investor. Individual income needs to be in excess of $250,000 annually and net worth in excess of $1 million. According to Kay, "You can structure deals with people who are not accredited investors. However, the disclosure that you have to do approaches prospectus level disclosure, and, therefore, I have never done a deal when there has been a non-accredited investor."

Closing a Transaction with Unaccredited Investors

The contributing seller does have alternatives if some of the limited partners he is involved with are unaccredited investors. His legal counsel should have experience in arranging transactions that alleviate this issue. Depending on the structure of the contributing seller's company, creative solutions may be found.

> First, say you have a limited partnership with a general partner and several limited partnerships below in the structure at different entity tiers. At the bottom of the tiers you have three accredited and one unaccredited investor. You can structure the deal so the OP units are held in the upper tiered limited partnership and meet security regulations.

[33] Ibid

> Second, we do not write opinions on this, but we have structured enough deals such that the sellers get comfortable with the tax advice they are getting that they work. Let's say we have a simple limited partnership with a general partner that is accredited. There are limited partners who just want cash, some do no want to play in the REIT market, some just need cash, others are unaccredited and need to get out of the deal structure. The general partners or other limited partners can buy out the unaccredited investor. However, this puts them at risk if the transaction does not go forward and sometimes they do not have the cash to do it.
>
> What we can do is have the REIT purchase the partnership interests of the unaccredited investor or the investor who wants cash. The REIT will step into the shoes of the unaccredited investor by way of the assignment of partnership interests for cash. Then the property owner limited partnership deeds the property to the operating partnership of the REIT pursuant to a deed and receives units equal to 100% of the purchase price. This entity then distributes those units out and the REIT is standing right there (in the place of the unaccredited investor or those who wanted cash) and gets back the units having the value equal to the cash that is used to buy the limited partners out. So it is a wash for the REIT, but it gets the unaccredited investor out before the units are delivered to the limited partnership. You have got to get the people who have to take cash out in advance and then you deed it and put the units in. This is an interesting structural twist that we can do when we have problems. [34]

These examples are meant to illustrate that there are complex legal issues that require proper advice to capture the tax deferred benefit of a REIT transaction. While there are specific security laws, there are ways for the contributing seller to receive OP units despite having non-accredited investor partners.

Registration Rights Agreement

The registration rights agreement attached to the contribution agreement specifies the rights the contributing seller will have after the closing. This document also contains clauses typically associated with a real estate closing, including representations and warranties and pro rata adjustments.

The registration rights agreement contains the negotiable clauses that affect the liquidity of the OP units and stock.

[34] Ibid

> Very frequently, unsophisticated sellers will go into these deals believing their currency is as liquid as cash. But in fact it is not. Legally, it needs to be subject to different kinds of restrictions. There need to be, for the REIT, periods in which the seller cannot sell his shares in the marketplace.[35]

Black-out periods, the restrictions placed on trading shares or OP units, are located in the Registration Rights Agreement. Both the timing and quantity of OP units and stock available to sell will be outlined in the agreement.

Tax Protection Agreement

Tax Protection Agreement clauses may be written directly into the Contribution Agreement. In a DownREIT transaction, Tax Protection Agreement clauses would be written directly into the partnership agreement. It is possible, though, that these clauses would exist in the closing documents and it would be attached to the Contribution Agreement. The lock-out periods, in which the REIT is restricted from reselling the assets, is found in the Tax Protection Agreement, as well as the REIT's right to engage in a 1031 tax free exchange.

Representation

Tax Advice

Understanding the taxable liabilities of a transaction is the first priority for the contributing seller. As illustrated in the REIT Roadmap in Appendix 1, engaging a qualified tax consultant is the first step for a successful transaction. There are full service law firms, which posses both a qualified tax department and a real estate component. Otherwise, the contributing seller should consult an outside accounting firm for specific tax advice. This outside firm should not only be competent to determine the assets' basis, but also be familiar with the tax issues of a REIT transaction. The contributing seller should be aware that the IRS has not yet officially ruled on the legitimacy of certain transaction issues. As noted earlier, the nature of bottom dollar guarantees and certain instances in which the REIT steps in for non-accredited investors have yet to be addressed by the IRS.

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[35] Ibid.

Legal Advice

The level of legal sophistication increases in real estate transactions involving a REIT. Proper legal support is essential in avoiding surprises that could lead to future tax and legal liabilities. The contributing seller needs counsel familiar with both UPREIT and DownREIT transactions, potentially from both sides of the table. Some law firms have represented both contributing sellers and REITs. These firms know what issues REITs will negotiate with a hard line approach and advise the contributing seller accordingly.

The legal team will outline the deal structure, work with both the tax advisor and brokerage firm, and conduct the negotiations. This thesis cannot emphasize enough that transacting with a REIT signals a long term investment and relationship with the REIT. Previously, real estate transactions were completed and both parties would part ways. In these agreements, the contributing seller is tied to the public company for possibly the rest of his life. He will need counsel to foresee all the liability issues that could arise.

Brokerage

The broker's responsibilities will include:

1) the production of the investment package that is sent to prospective purchasers,
2) working with legal and tax advisors in creating the investment memorandum,
3) and assisting the closing of the transaction.

The contributing seller has several options when considering the appropriate brokerage representation. The first option is a local or regional real estate broker. Their advantage is local market expertise. In contrast, they will likely be less sophisticated in understanding real estate capital markets. Another option would be to utilize an investment bank. They can perform the brokerage function and are experts in the capital markets. They also have more experience in property transactions with REITs. Their potential weakness would be a lack of local knowledge in a specific market. They have the staff necessary to perform proper due diligence, but this comes at a cost. A third option is a real estate advisory firm, AEW Capital Management for example, that has the capabilities of performing the necessary brokerage functions. Some contributing sellers already have an existing relationship with certain firms, which they may then turn to for advice.

Chapter Five: The Integration of Issues and Motivations Illustrated by Transactions

This chapter will integrate the issues previously discussed in general terms with the actual motivational factors of contributing sellers in closing transactions. Through a series interviews and released statements with the parties involved in REIT transactions we will provide case studies reflecting the issues deemed important by the contributing seller. This chapter is meant to allow contributing sellers to learn from the experiences of others that have gone through the same process.

Baur Properties and Duke Realty Investments, Inc

The Transaction

Baur Properties was a small private firm in St. Louis in business since the 1950's. Their strategy was to develop properties on their own account with a long term holding period. Their local expertise allowed them to successfully compete in the office and industrial sectors in St. Louis. They maintained lower debt levels on their assets relative to other private real estate companies, at about 60%. This was one of the factors in Baur's ability to live through several real estate cycles, including the real estate depression of the early 1990's. Baur began to feel that their deal by deal financing strategy, a construction loan followed by a mortgage, had become inefficient[36].

On October 3, 1997, Duke Realty Investments, Inc. bought the operations and holdings of Baur Properties. The eleven properties totaled over 980,000 s.f., and included the Maryville Center, one of the largest office complexes in St. Louis.[37] Baur also contributed the development rights to accommodate approximately one million square feet of office space. Duke assumed and agreed to maintain the debt on the assets, which had an average of seven years remaining before it was fully amortized. There was a ten-year lock-up period in which Duke could not sell the assets, although a make-whole provision was included if Duke violated this clause. The transaction included that Mr. Edward Baur, the Chairman of Baur Properties, would join Duke's Board of Directors.

[36] Interview with Birch Mullins, Duke Realty, St. Louis, MO, July 15, 1998
[37] Donna Coppinger, Duke Realty, Press Release, October 3, 1997

The Motivation

Birch Mullins, a former principal with Baur Properties, detailed the issues that motivated the transaction with Duke. He noted a change in risk aversion levels as he and his partners entered their fifties. They began to look at several options in terms of the future of the company.

Diversification

Mullins cited diversification as one of the main drivers of the transaction. As noted previously, they were able to expand into eight cities and balanced the income characteristics of the portfolio by this one transaction. This satisfied some of their risk avoidance goals.

Estate Planning - Liquidity - Succession Issues

Despite enjoying working in real estate, Mullins had to consider how his separation from the partnership would occur. Long term management issues had to be addressed. He was going to need a way "to get off the train", as Mullins explained, receive his value in the company, and allow the company to continue to exist while employing over twenty individuals. This case study reveals that both the liquidity interests of the contributing seller and the future employment opportunities for his employees drove the transaction.

Baur chose Duke Realty for several reasons. However, Duke's willingness to absorb twenty employees from Baur and allow Mullins to continue to work in senior management was a major reason. Other REITs in the bidding process, Equity Office for one, did not offer this option in the negotiations and was eliminated accordingly. The transaction with Duke allowed Mullins to 'get off the train', continue to work in real estate - currently in a part time role, and look after the employees that had been loyal to Baur. The REIT transaction allowed Mullins to contribute his illiquid partnership interests in direct real estate investments in exchange for liquid forms of currency.

Investment Sales Market

Before Baur decided to contribute their assets to a REIT, they considered other alternatives. Given the competitive nature of the business they felt a joint venture with a pension fund could give them a competitive advantage. First, the capital would allow them to aggressively pursue development opportunities. Second, given the partners increased risk aversion levels, a joint venture would have possibly allowed them to reduce their debt levels to below 50%. This option however, did not solve their management succession issues, and would actually further complicate the division of partnership interests when Mullins decided to 'get off the train'.

They spent a brief time considering going public themselves. They did not spend tremendous "brain damage" on this option, as their net asset value was minimal in comparison to the ever-growing office and industrial REITs. Next, they studied the REIT market and potential buyers, and began the due diligence process. They retained Prudential as their investment banker and maintained their long-term relationship with a private accounting firm.

Other Motivating Factors

Baur was a developer as well as a real estate investment company. At the time of their transaction, some REITs were principally interested in acquisitions and were less concerned with development prospects for their REIT. Equity Office, which shared this viewpoint on development, was ruled out for this reason as well. Baur's management desired to continue to work in the field in which they had become successful. Duke Realty accepted Baur for the potential to pursue development as a growth strategy. Other REITs are also attempting this strategy.

Finally, Mullins stated that this transaction, which allowed for a large tax liability to be deferred, created an attractive proposal. As stated in Chapter Two, the tax deferred benefit alone is not why the company contributed its assets to the REIT. The tax benefit created a better return to the partners, as they may never convert their units into stock, thereby writing up their basis in the assets upon death, benefiting their estate. The motivational drivers for the transaction were succession planning, diversification, liquidity, the nature of the investment markets, and the well being of the employees that had been loyal to Baur for years.

Joseph P. Kennedy Enterprises and Vornado Realty Trust

The Transaction

Joseph P. Kennedy began investing in real estate in the 1940's in an attempt to diversify his successful liquor business and his portfolio of stocks. He acquired the Chicago Merchandise Mart building in 1945, a 3.7 million s.f. commercial building equal in square feet to the Sears Tower. His family more recently continued to expand its real estate holdings, building the 1.3 million s.f. Apparel Center in Chicago in 1977. In 1982, the family developed the 433,000 s.f. Washington Design Center and in 1990 they built 400,000 s.f. Washington Office Center, both in Washington D.C.[38] While the real estate business was a success for the Kennedy family, Christopher Kennedy, the son of former Senator Robert F. Kennedy, was the only grandson of Joseph to continue in the real estate industry.

Vornado Realty Trust acquired the Merchandise Mart and the Apparel Center in Chicago and both Washington D.C. properties for cash, securities, and debt valuing $625 million. The transaction included $465 million in cash, $50 million in assumed debt, and $110 million in OP units and Convertible Preferred OP units.[39] The property and trade show management company was also included in the transaction.

The Motivation

Through a series of conversations with, and press releases from, the office of Christopher Kennedy, Executive Vice President of Merchandise Mart Properties Inc., we were able to learn of the driving forces of this transaction. Merchandise Mart Properties Inc. is the management company for each of the buildings involved in the transaction.

Diversification

While diversification was not the primary driver in this transaction, it was a consideration. With the acquisition of over $100 million in Vornado OP units, the Kennedy family is now investing in a REIT with a $3.083 billion market cap.

[38] "The Kennedy Clan Decides to Cash in its Last Big Business", Wall Street Journal,, Jan 26, 1998
[39] Marce Buckman, Merchandise Mart Properties, Inc, Press Release, Jan 26, 1998

Estate Planning - Liquidity - Succession Issues

> In the case of families, a transaction like this gives the second and third generations the ability to make their own individual decisions about whether to sell their shares and pay their taxes. As you get further along in generations there may be a less commonality of interests.[40]

> The deal will allow the managers of the Kennedy family fortune to make decisions based on individual beneficiary needs. [41]

This decision-making flexibility was a tremendous motivational driver in closing the transaction. As stated above, Christopher Kennedy was the only heir to continue in the family real estate business. A vehicle was needed to equitably divide the value of the assets, and allow for individual control of investment decisions. Information on the exact number of beneficiaries in the transaction was not available. However, Senator Edward Kennedy and the eleven surviving children of former President John F. Kennedy and Senator Robert F. Kennedy are among the participants. Given the number of individuals involved, estate planning and the liquidity issues, combined with the tax deferred benefit of the OP units, were the main drivers of the UPREIT transaction with Vornado.

The Kennedy estate had a clear division of interests. The majority of family members were involved in other businesses, ranging from politics to documentary filmmaking. However, the contribution of assets allowed Christopher Kennedy to continue in his role as Executive Vice President of the real estate management company. Vornado agreed to a five-year employment contract. This allows the family to gain the liquidity of divesting from physical assets and maintains the right for Christopher Kennedy to continue managing the family's former real estate empire.

Investment Sales Market

"Only a fool waits for top dollar", Joseph P. Kennedy

The timing of the transaction allows the Kennedy family to become large investors in Vornado Realty Trust, which had risen in value 83% for the year prior to the closing. Joseph Hakim explained, "We held the Mart for 50 years; now we are going to hold Mr. Roth's (Vornado's)

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[40] "The Kennedy Clan Decides to Cash in its Last Big Business", Wall Street Journal,, Jan 26, 1998
[41] Ibid

stock for years." As part of the agreement, Vornado agreed to a twenty-year lock-out period.

Other Motivating Factors

The tax deferred benefit greatly improved the overall quality of the transaction, and was noted as a driving force by the Kennedy family. The building was purchased for only $13 million, and then held for over fifty years. Despite extensive renovations, previous depreciation allowances would result in a tremendous capital gains and depreciation tax liability if the assets were sold outright. The tax liability on $110 million in OP units is deferred until the units are converted, and the basis is written up upon death of the OP unit holder.

Resorts L.P., Carefree Resorts Corp. and Resorts Services and Patriot American Hospitality, Inc.

The Transaction

In January 1997, Patriot American, a paired-share REIT, acquired the assets and management company from Resorts L.P. and Carefree Resorts for $210 million[42]. The assets consisted of The Boulders, a 160 room hotel, retail mall, two golf course resort in Scottsdale, AZ; The Lodge at Ventana Canyon, a 50 Room hotel, two golf course resort in Tucson, AZ; and the 50% partnership interests in both The Peaks Resort, a hotel and condominium complex in Telluride, CO; and Carmel Valley Ranch, a 100 room hotel in Carmel, CA.[43] Each asset also had pre-approved development rights.

The contributing seller's partnership consisted of an 80% presence by tax-exempt institutional investors. The contributing partner used their retained private law firm, Eastdil as their marketing agent, Ernst & Young Kenneth Leventhal for tax advice, and the financial advisory services of AEW Capital Management. This thesis concentrates on the taxable partners' motivations, however, it is important to note that the timing of the transaction was influenced by the presence of tax exempt entities. This provides an illustration for private owners of real estate that also have institutional investors in the partnership structure. It is also noted that:

[42] Carefree RESORTS Press Release, Jan 20, 1997
[43] "Patriot American Completes Acquisition", Patriot American Press Release, Jan 27, 1997

> The Carefree acquisition transaction marks Patriot's first application of the paired-share REIT structure, according to Patriot President and Chief Operating Officer, Thomas W. Lattin. Once the paired-share structure closes, Patriot will receive substantially more of the cash flow from the management of its hotel properties including the Carefree properties, while still retaining its REIT tax advantages in a non-conflicted structure.[44]

The paired-share REIT structure allows the REIT to recognize income from non-real estate activity through the REIT structure. There are four such REITs that were allowed to retain their special status through a grandfather clause in the government tax revision laws passed in 1986. The paired-share REIT structure is beyond the scope of this thesis, however, is important to note that Patriot American is a paired-share REIT.

The Motivation

Mr. Russ "Rusty" Lyon Jr., founder and managing general partner of Carefree Resorts, was the majority investor in the private partnership involved in this transaction. It is through his perspective that this thesis will address the motivation of the transaction.

Diversification

Diversification of Lyon's real estate or investment portfolio was not a driving force in the decision to contribute his assets to Patriot American.

Estate Planning - Liquidity - Succession Issues

Similar to the Baur-Duke transaction, the continued employment of some of the workforce was a major issue in the process of selecting a REIT. In contrast to Mullins, the majority partner, Lyon, was not interested in transferring to Patriot. Starwood Lodging, Crescent Realty, and Patriot American were finalists in the bidding process. Each offered the same price for the portfolio. However, of the three, Patriot offered the best transition for the existing staff of about ten employees. In addition, to the continued existence of the their jobs within Patriot, they were offered stock options.

[44] Bess Gallanis, The Financial Relations Board Press Release, Jan 21, 1997

While, Lyon was pleased with the liquid nature of the assets he received, he did not stress that the transaction was completed to liquefy his assets for retirement or estate planning.

Investment Sales Market

Lyon's company had chosen to become partners with several institutions in these projects. The main motivational driver to sell was the exit strategy these institutions could realize given a sale to a REIT in the current investment sales market. REITs were acquiring aggressively and wished to grow. As Lyon proceeded with due diligence, he felt it was in his best interest to sell his partnership interests as well.

The tax-deferred benefit of the OP units was an attraction for Lyon in determining to sell to the REIT. His units were valued at $19.00 at the time of the transaction, reached as high as $34.50 and are currently priced at $19.69. While he once felt like a 'genius', he has been disappointed in the REIT's stock performance of late.

The agreement did not have a lock-out period. The REIT is not restricted from re-selling the assets. Although this is unusual, Lyon is convinced that it is unlikely the REIT will sell these assets. He referred to them as "the bell-cow of the portfolio which allowed Patriot to get involved in the niche business of resort properties." Lyon is aware that he is exposed to tax liabilities if Patriot does choose to sell the properties. There were no lock-up or black-out periods in the agreement either. In a more recent transaction that Lyon has been involved in, he has incorporated ten and fifteen year lock-out periods in the contribution agreement. Lyon referred to the lock-out periods as stand still agreements.

Lyon stated that had he and his partners retained an equity interest in the properties, rather than contributing the partnership rights to another entity, they may have had greater returns. Lyon felt that he and his partners had appropriate reasons to sell at the time. However, they may have been able to negotiate better control provisions, and been more involved, had they negotiated to remain an equity investor in the partnership and allow only the institutional investors the opportunity to divest on their own to Patriot.

Chapter Six: Conclusion

Purpose of Thesis

The purpose of this thesis is to identify the many interrelationships among transactions between private owners of real estate and REITs. The framework presented is intended as a guide for private sellers. Our goal is to explain particular issues as well as organize them into categories. By using the framework, contributing sellers will understand the scope of the issues they may face during a transaction. Hopefully, the issues explored in the thesis will assist contributing sellers in asking the right questions.

Contributing Seller's Perspective

The REIT Roadmap, found in Appendix 1, illustrates the transaction process. In approaching a transaction, the contributing seller should first determine his tax position and understand the reasons why he wants to sell. Next, the contributing seller considers the range of optimal currency for the transaction given his motivation, tax position, and investment strategy. The contributing seller may then examine the REITs interested in transacting with his private company and perform due diligence. Perhaps the financial terms offered by several REITs are similar, and control issues will be the deciding factor. Perhaps covenants and provisions that allow the contributing seller's organization to continue are the most important factor, or the length of the tax deferral period.

The value of REIT stock and OP units fluctuates depending on the market. What is the contributing seller's strategy in negotiating the transaction? Should the contributing seller try to extract as much cash up front or hold out for securities in order to capture equity appreciation down the road? When the transaction is completed, what options are available to the seller? How much could the contributing seller borrow against a portfolio of OP units? Are their innovative financial products or services allowing the contributing seller to gain liquidity, diversification, or increased returns with his securities?

Contributing sellers should take into account the future of the REIT industry. Will Congress change the REIT laws? Will the IRS challenge components of UPREIT or DownREIT structures? How will the REIT sector perform during the next downturn? How will REIT stock perform over time, and will the securities remain highly correlated with real estate? How volatile is REIT stock relative to other securities over time?

Summary of Issues

Motivation and Taxes

This thesis explores multiple sets of issues. First, we examined motivational factors driving REIT transactions with contributing sellers. Executives we spoke with noted a variety of forces influencing their decision to contribute assets to a REIT including:

- securing a management role for current employees,
- estate planning concerns,
- benefiting from the current investment sales market,
- and achieving greater liquidity and diversification.

Using a series of examples we examined tax issues, illustrating the benefit of tax deferral. In cases in which the contributing seller had little basis left in the asset, the value of the tax deferral was significant. We also discussed the implications of the seller's taxable position on currency selection.

Financial Issues

Given an understanding of the seller's taxable position and the value of the asset portfolio, the contributing seller is in a position to judge what is the range of optimal currency. We discussed the positive and negative characteristics of the three types of currency: cash, stock, and OP units, as well as combinations of these currencies. In all the transactions we studied, the contributing seller received a combination of currency in exchange for an asset or portfolio of properties. Although OP units are similar to shares, they also have unique characteristics including:

- that receiving OP units is a non-taxable event,
- that the holder's basis in the OP units is stepped up at death,
- that OP units holders have no voting rights,
- possible legislative risks,
- and the non-uniformity of control covenants related to OP units of different transactions.

Some contributing sellers may be less familiar with OP units, recent changes in the real estate capital markets, and REITs. Our goal was to familiarize the reader with these subjects. In addition to discussing OP units, we also examined the REIT evaluation process, due diligence, the REIT industry's recent history, and basic definitions.

In one transaction we studied, different REITs bidding for a private asset portfolio offered similar prices. In this case, the deciding factor for the contributing seller was the control provisions. The lock-out period, the length of time the REIT is required to hold the asset is especially significant since the contributing seller may face a large tax liability if the REIT divests the contributed assets. Our examination of this provision, as well as other covenants, allows the contributing seller to visualize the relationships between financial issues and control issues.

Finally, from our discussions with professionals at firms like AEW, we believe that the OP unit holder may benefit from future financial products and services. As the REIT sector matures, contributing sellers may have more opportunities, post-transaction, to exchange their OP units for units in a diversified fund of OP units. The OP unit fund, composed of OP units from a variety of contributing sellers and transactions, potentially offers greater diversification and returns. As lenders gain confidence in OP units and OP unit funds, contributing sellers may have several choices to finance off of their OP unit portfolios. After examining financial issues, we studied legal issues.

Legal Issues

The contributing seller should understand the differences between UPREITs and DownREITs, as well as the documentation he is likely to encounter in the course of a transaction. Representation, legal and otherwise, is an important factor given the sophistication of these transactions. Contributing sellers should consider whether they will be best served by real estate professionals they worked with in the past, particularly, if these individuals lack experience in the capital markets. Now that we have summarized financial and legal issues, we will share some of the lessons we learned during our research.

Lessons Learned

Our research revealed interesting insights into private to public transactions. In our research we were surprised by some of the data we collected. Our investigation revealed a wider variance of transaction terms than we expected, especially in control provisions. Some contributing sellers seemed less concerned with the REIT's ability to divest an asset down the road, believing the REIT would have no incentive to divest. Others cited the ability of management to continue to operate, as an important concern. A lawyer familiar with these transactions noted the lack of standards in the transaction terms across deals and the effort required to produce documents unique to each deal. The variance in transaction terms reflects the wide variety of individual preferences and concerns driving these transactions as well as the rapid changes taking place in the REIT industry.

Future Research

The issues raised by our framework provide a basis for future research. How will these private to public transactions be viewed in five years, in ten years, or after the next real estate downturn? A wide variety of transactions using a relatively new financial vehicle have occurred between 1992 and 1998. In the future, what will contributing sellers, REITs, and investors think about today's transactions. How have the securities involved in these transactions performed? Studying the short, medium, and long term results of these deals will continue to be interesting research.

Which party captures the value of tax deferral offered by transactions between private owners and REITs? Answering this question will be interesting if the dynamics of transactions between contributing sellers and REITs changes. Some practitioners we spoke with were surprised that the full benefit of tax deferral still accrued to the contributing seller since the REIT brings the deferral opportunity to the table. Others predicted that the status quo may change. Studying this change, if and when it occurs, would also provide insights into the transaction negotiation process.

Does the change of ownership from private to public affect the underlying assets of the contributing seller's portfolio? What do public companies do differently from private companies, if anything, in terms of the assets? Is there more of an arms length relationship between tenant and owner with public companies. The scope of this thesis was private to public transactions, however, the transfer of assets from the private realm to the public domain raises many issues suitable for further study.

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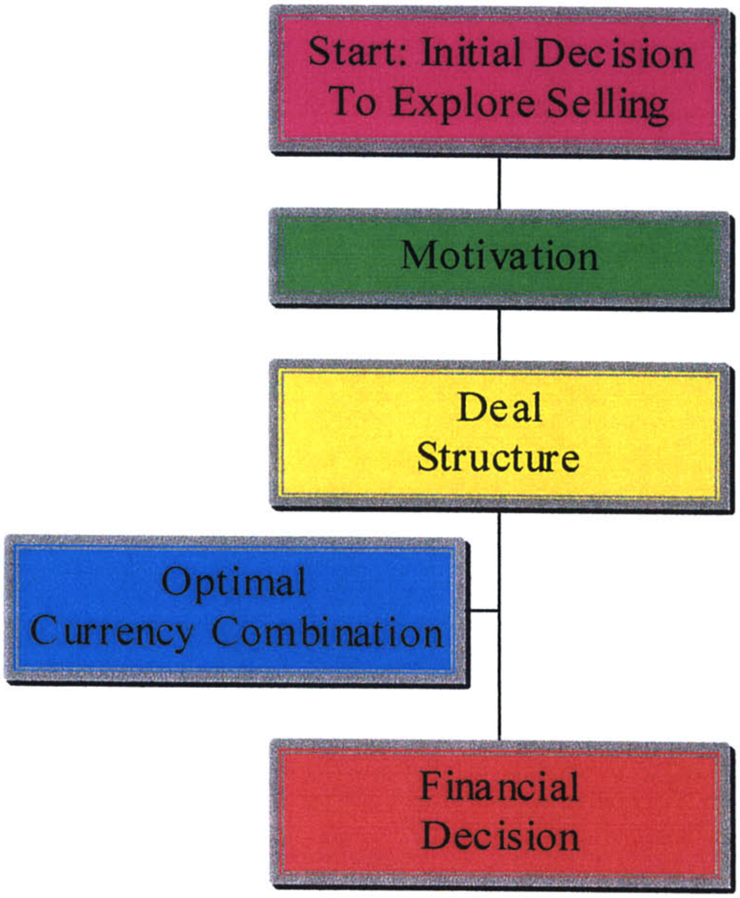
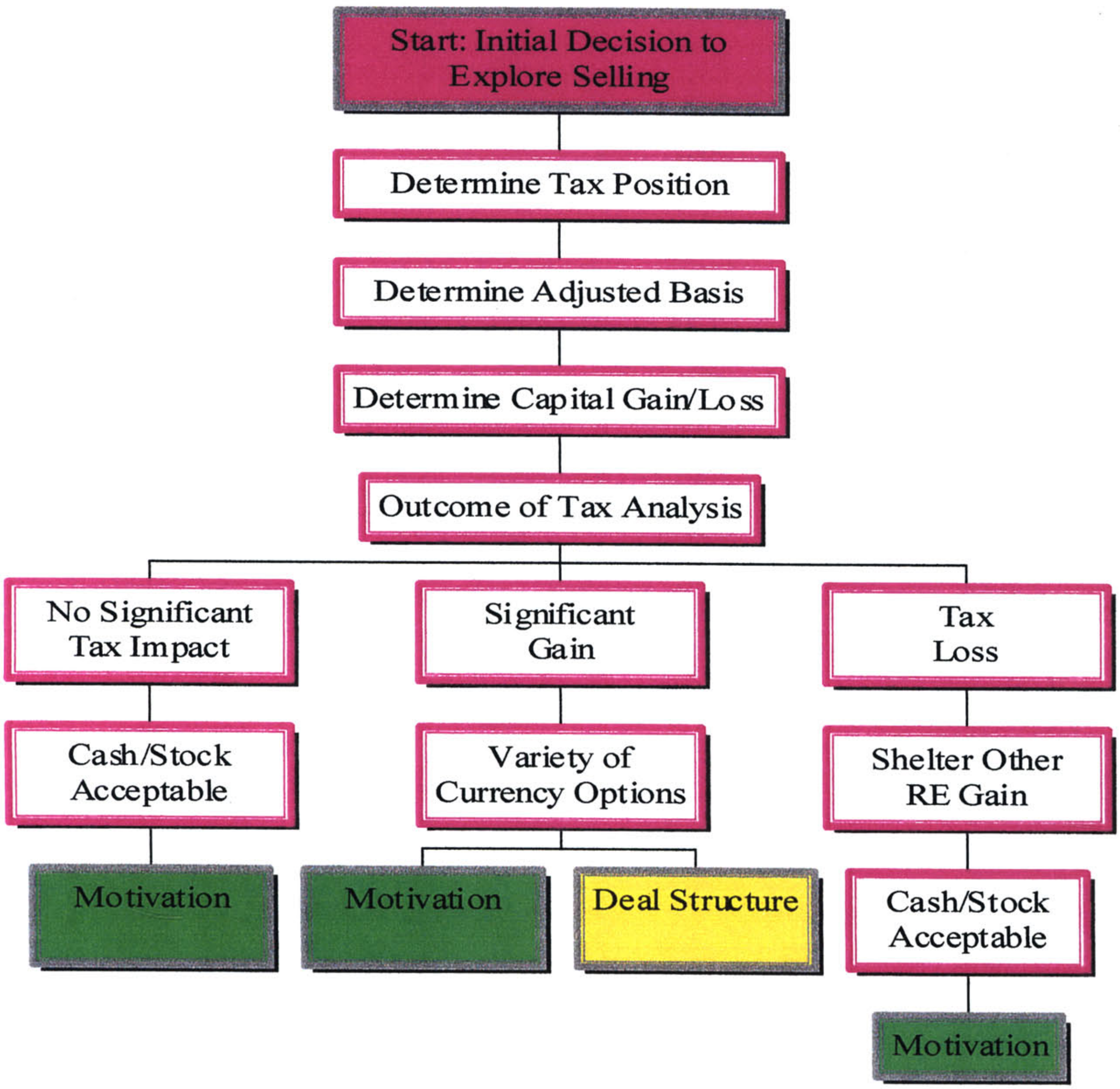
Appendix #1:
The ROADMAP to REITLAND



THE REIT ROADMAP
STAGE ONE



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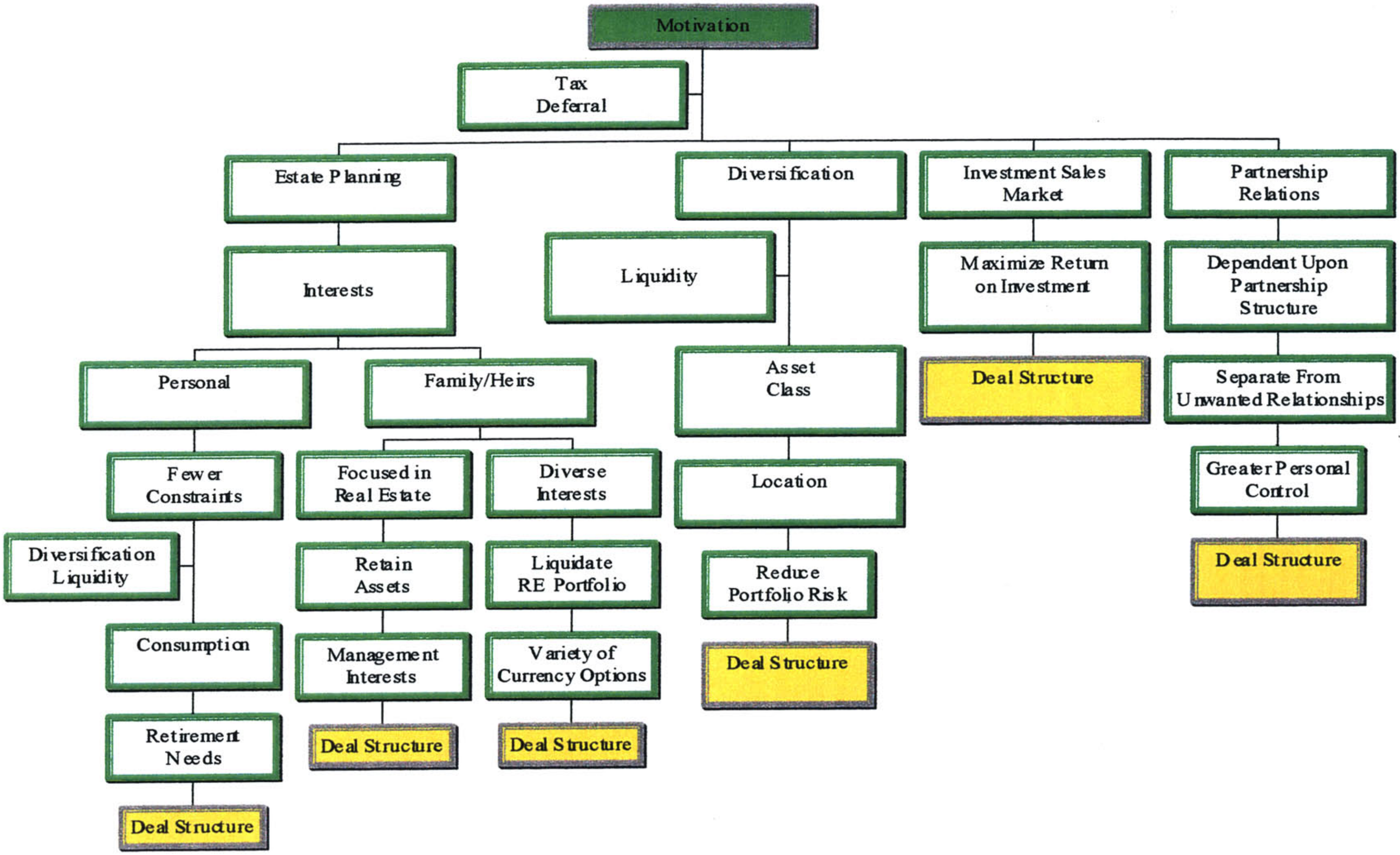
STAGE TWO



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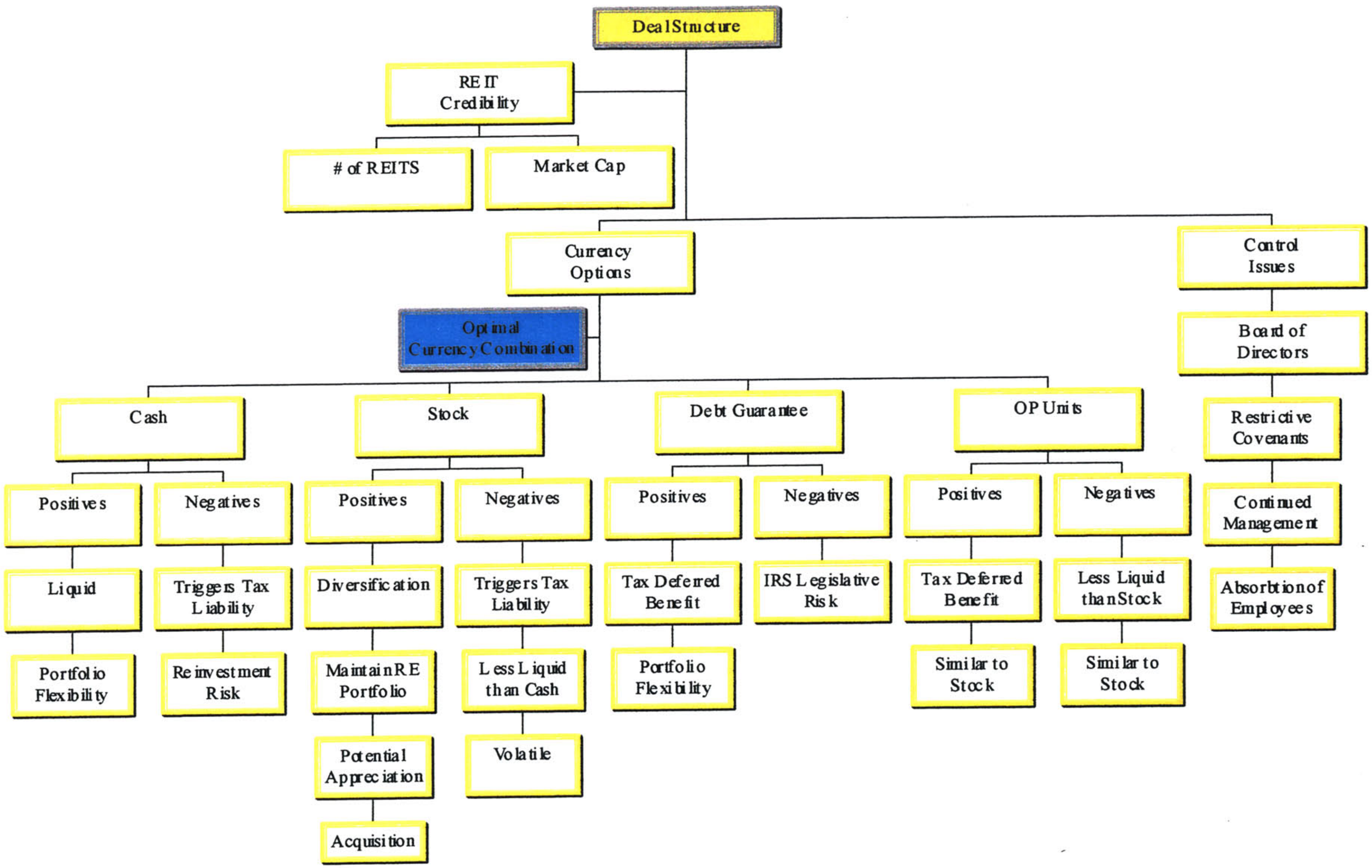
STAGE THREE



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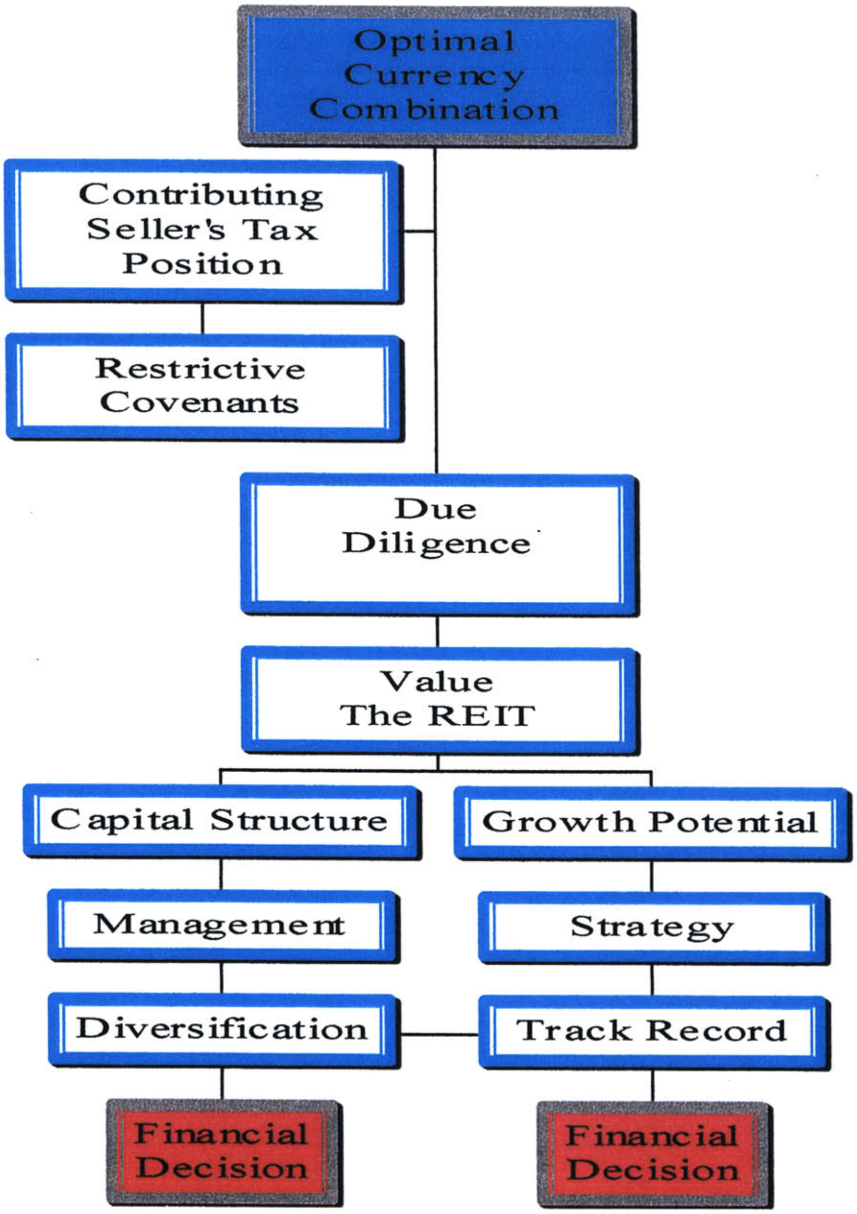
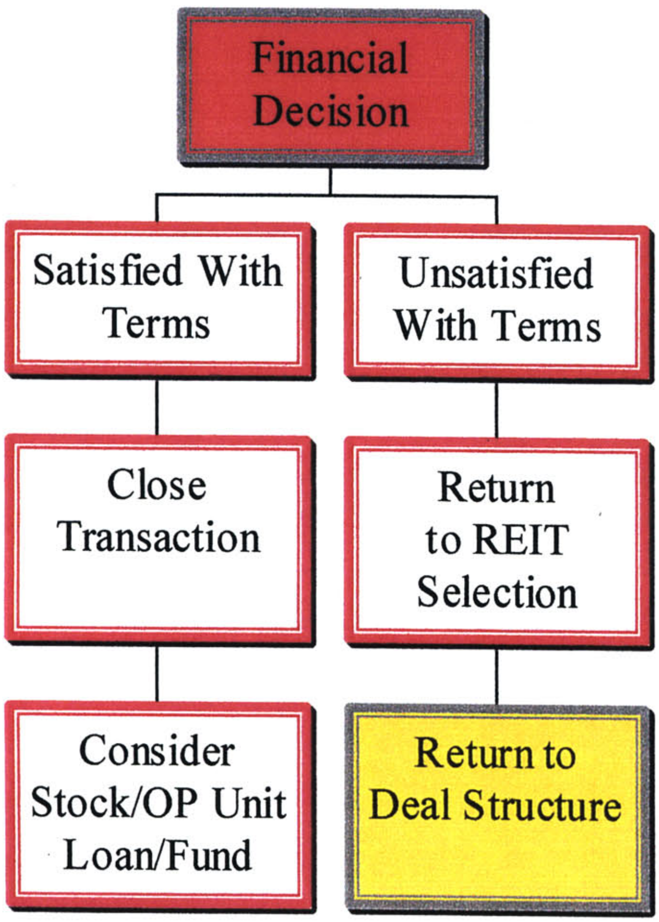
STAGE FOUR



THE REIT ROADMAP
STAGE FIVE



Appendix 2: Assumptions For the Thesis Examples:

This thesis will illustrate several topics with the use of a real estate transaction. For the purpose of uniformity, each example will draw from the same base case. The data below outlines our assumptions for the transaction.

The property was acquired by the owner thirty years ago for $30 million. Fifteen percent of the purchase price was allocated to the land. He immediately spent $3 million in captial improvements.

The property was refinanced in year twenty of the holding period, or ten years ago. The debt information and amortization schedule is attached.

Base Information: As of todays date, the 30th anniversery of the purchase date.

Original Purchase Price	30,000,000	
Value attributable to the land	4,500,000	15% of purchase price
Original Equity	9,000,000	30%
Original Debt	21,000,000	70%
Capital Improvements	3,000,000	in year one
Depreciation Schedule	39	years straight line
Market Value at Contribution	40,000,000	
Capital Gains Tax Rate	20%	
Tax Rate on Depreciable Gain	25%	
Tax Rate for Tax Exempt Entity	0%	
Market value in four years	45,000,000	
Contributing Sellers Marginal Federal Income Tax Rate	39.6%	
Investor's/Contributin Seller's Expected rate of return	10%	
# of periods remaining on Lock-up in four years, year 34 of holding period	3	

Appendix 3-- IRS Section 1031: Tax-Free Exchanges

In General

1031 exchanges are used to exchange properties without recognizing gain or loss. For like-kind exchanges, Section 1031, furnishes the statutory authority for exception from the general rule requiring the recognition of gain or loss upon the sale or exchange of property.[1] The purpose of this appendix is to summarize 1031 exchanges in the context of REIT transactions, as opposed to a detailed accounting. If a REIT engaged in a 1031 exchange with another party (REIT or non-REIT) of the asset originally exchanged by the contributing seller, the seller's tax basis would also be transferred.

Definition

"No gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like kind which is to be held either for productive use in trade, business, or for investment."[2] The primary concepts of this provided by this section include:

- Section 1031 applies to gain or loss resulting from a like-kind exchange.
- Non-recognition id mandatory, not elective.
- Section 1031 property must be like kind and used in a trade or business or held for investment

Furthermore, any losses that result from a like-kind exchange are a deferred as well as gains. While deferred gains are not currently taxable under Section 1031, any deferred losses are nondeductible. From a practical standpoint, many types of assets, especially commercial properties qualify as like kind. An intermediary is often used in these exchanges. An intermediary is a party to the transaction who assumes the liability of exchangor, seller, and/or buyer. An intermediary serves as a conduit, has no fiduciary responsibility to the exchangor, and is compensated.

Example

The following is an example of a basic exchange of a single asset:
Mr. Metaxa exchanges an investment lot A, for another lot, B; both lots are valued at $75,000, and qualify for like-kind treatment. Mr. Metaxa's adjusted basis for the lot is $50,000; therefore he realizes $25,000 in gain, which is deferred under Section 1031.

Market value, lot B, "Amount realized"	$ 75,000
Adjusted basis, lot A relinquished	(50,000)
Realized gain--deferred	$ 25,000

If Mr. Metaxa had sold his lot for $75,000 in cash, the entire gain of $25,000 is taxable. Because Mr. Metaxa qualifies for a like-kind exchange, the entire gain is deferred. After the exchange, the adjusted basis for the new property, lot B, is $50,000, which is determined in reference to the property relinquished (Section 1031(d)).

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[1] Real Estate Exchange, Using Tax-Deferred Exchange in Real Estate Investment Management, Zuckerman and Stone, 1993.

[2] IRS Section 1031(a)(1)

Appendix 4

Final Acquisition Offer Guidelines

Final acquisition offers are due Friday, June 26, 1998 by 5 p.m. Eastern Daylight Time.

BUSINESS / REAL ESTATE ISSUES

1. ***Contract Documents*** – Please provide a copy of the form contract documents you would intend to use to close this transaction.
2. ***Closing and Due Diligence*** – Please confirm your desired closing and due diligence timeframes and your expectations concerning closing costs. Please provide your due diligence checklist.
3. ***Title Documentation*** – What title documentation would you expect in connection with this transaction?
4. ***Environmental Due Diligence*** – What type of environmental due diligence would you expect to conduct in connection with this transaction?
5. ***Warranties*** – What are your typical post closing warranties? These need to be limited to under 12 months and limited in scope.
6. ***Intact Package*** – The properties have been offered as a package. Please discuss your expectations should any due diligence issues arise regarding a specific property.
7. ***Earnout Allocation*** – What are your proposals for dealing with the purchase of properties still under lease-up or construction. Please propose a specific formula.
8. ***XYZ Employees*** – What are your intentions about the future employment of XYZ property management personnel?
9. ***XYZ Development Agreement*** - Please discuss the extent of a future development relationship with XYZ. How would that agreement be structured?

PURCHASING ENTITY RELATED ISSUES

In addition to the above business/ real estate related issues, we ask that you specifically address the following issues related to your company, its goals, expectations and business direction.

1. ***REIT Industry Consolidation*** – How do you view your company in relation to the current consolidation taking place in the REIT industry?
2. ***Geographic Focus*** – What is the current and expected future geographic focus of your company?
3. ***Asset Type Focus*** – What is your current and expected future focus?
4. ***Internal and External Growth Projections*** – What are the company's growth expectations both internal and external and how do you expect to achieve these?
5. ***Impediments To Growth*** – What does your company perceive as its greatest challenges to achieve their growth expectations?
6. ***Credit Ratings*** – What is your current credit rating and what are the company's goals for this in the future?
7. ***Leverage*** – What is the company's current leverage position and what are the company's goals with respect to the use of leverage?
8. ***Stock Performance*** – Please discuss the company's historical stock performance and expectations for future stock performance? Does the company desire to be classified as a growth stock or as an equity income stock?
9. ***Dividend Payout Ratio*** - Please discuss issues related to the company's current dividend as it relates to your payout ratios and yield and what are the company's goals and expectations for future dividend ratios.
10. ***Ownership Profile*** - Please discuss the company's current ownership profile as it relates to institutional vs. non institutional holders.

SECURITIES/OPERATING PARTNERSHIP ISSUES

1. ***Partnership Agreements*** – Please furnish a copy of any partnership operating or other organizational agreements that form a part of your REIT structure that would be a material element of this transaction.
2. ***Charter Provisions*** - Are there any anti-takeover provisions in the company's charter?
3. ***SEC Disclosure*** - Assuming that all of the beneficial owners of the portfolio properties would be accredited investors for SEC purposes, what type of registrations/ disclosure procedures would you expect to employ in order to effect a transaction in which operating partnership interests are taken for a portion of the purchase price and what type of documentation relating to accreditation status would be required?
4. ***Lockout Period*** – It is expected that you will have a one year lockout period on the units. Earnout units should not be subject to any further lock out. It is also important that the conversion of units to shares and the resale of shares are registered on a shelf within one year of closing so that the shares on receipt are freely tradable without restriction. We also request a liquidity mechanism, in the event the shares cannot be sold, you will offer cash rights. Please confirm or clarify how you propose to address these issues.
5. ***Down-REIT vs. UP-REIT*** – What do you perceive to be the advantage/disadvantage of a Down-REIT vs. an UP-REIT? Based on your present structure please answer the following:

    a) What properties are currently included for use in this transaction and what properties would you in tend to include in this entity for future transaction?
    b) REIT stock conversion rights should be one to one for OP units with anti dilution protection for normal corporate reorganizations.
    c) What taxable income stream is available to support the distributions received by the owners of these interests?
    d) What are your current plans for disposing of any of the properties already in the partnership?

TAX RELATED ISSUES

1. ***Depreciation Allocation*** - What method has the operating partnership chosen for allocating to the contributing party depreciation attributable to contributed real estate?
2. ***Asset Disposition*** - What assurance is the company willing to make to the contributing parties related to the future disposition of the contributed assets? Has the company previously disposed of any contributed assets and was there previous communication with the former owner? <u>It is requested that the partnership only dispose of assets via 1031 exchange as long as there is a contributing party that would be negatively impacted by a cash sale. Please confirm how you will address this issue.</u>
3. ***Debt Allocation*** - What is the anticipated debt structure of the acquiring operating partnership? Please specify nature of debt (recourse, non-recourse, guaranteed security, whether it is qualified non-recourse debt, etc) and indicate how much debt would be allocated to contributing parties following contribution.
    a) If there is "qualified non-recourse debt" does the operating partnership agreement stipulate a method of debt allocation to the partners?
    b) Is there any unsecured debt that could be allocated to the contributing partners and what form does this allocation generally take?
    c) What assurances is the company willing to offer to the contributing partners to maintain debt allocations to protect basis related issues?
    d) Identify anticipated changes in debt structure over the next five years other than ordinary amortization consistent with existing term of debt.
4. ***Partnership Interests*** - Assuming the transaction is structured as a transfer of partnership interests, are you prepared to accept substantially all (but less than 100%) of the partnership interests in order to maintain the partnership for tax planning purposes by the contributing partners?
5. ***REIT Status***- Please provide a copy of your most recent opinion regarding REIT qualification, including all underlying certificates, if any.